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C O L U M B I A U N I V E R S I T Y I N T H E C I T Y O F N E W Y O R K

Legal Background to the Low Profitability of Japanese Enterprises

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Abstract

Japanese enterprises have shown low profitability for quite some time now. This paper presents several hypotheses regarding the influence of Japan's legal systems on this phenomenon. The laws discussed in this paper cover not only corporate law but also 'enterprise law' as a whole, including bankruptcy law, capital markets law and civil litigation law. Besides, I examine not only the 'laws on the book' but also 'legal systems in practice'.

As for the research design of this paper, I identify major differences in the enterprise laws among Japan, the United States, and Germany. On the other hand, I assume incentive structures of the parties concerned, such as management, shareholders, creditors, investors and regulators that they play their role on the basis of economic rationality. Then I combine both examinations so as to consider the possible effects caused by the differences in legal systems.

Under this approach, this paper discusses the individual law system that may influence the behavior of the enterprises. First I discuss the business reorganization system. Here I point out Japanese enterprises might retain significant cash reserves to avoid the danger of being compelled to file for bankruptcy protection. To the next, I examine the takeover systems and argue that a potential bidder might regard the takeover of a Japanese enterprise as irrationally difficult. This system might bring about an insufficient industry reorganization and weak market pressure on individual enterprises. As for the shareholders' activities, I suggest that corporate governance disclosure system in Japan might provide negligible pressure on enterprises and investors because of the separation of corporate law and market law. Concerning the enforcement of enterprise law such as lawsuits by shareholders or actions by regulators, I show that the characteristics of enforcement system in Japan might contribute to weak market discipline and risk aversion in the business decisions of directors.

I hope this paper stimulates further research and widespread constructive discussion on this issue.

Introduction¹

The purpose of this paper is to present several hypotheses regarding the influence of Japan's various legal systems on the profitability of Japanese enterprises to stimulate the interests of scholars and policymakers on this issue.

Japanese enterprises have shown low profitability for quite some time now. Despite these companies retaining more cash on their balance sheets than ever before, their profitability continues to decline. As will be described in section 1, Japanese enterprises show striking differences in financial performance with their US and European counterparts. In Japan, listed firms have greater cash reserves and lower profitability than their foreign equivalents.

The poor performance of Japanese enterprises is a serious problem, and more so in view of Japan's stagnant economy (this period has been labeled the 'two lost decades') and sharp decline in its labor force. The low profitability of Japanese enterprises is the result of their poor value-added productivity, which results in lower productivity in the national economy.

In this paper I wish to investigate the reasons behind this phenomenon to assist in the structural reform of the Japanese economy. Thus, the analysis contained in this paper requires a strong basis on economic rationality. I also believe that the discussion should not rely on non-economic factors such as Japan's unique management style because such factors cannot be reformed.

I assume in this paper that Japan's unique legal systems have resulted in the unique behavior of Japan's companies; that is, behavior different from their foreign counterparts. As a country's legal rules act as a fundamental background to the business activities of enterprises, they have significant influence on their performance. In addition, legal systems can be reformed via rational decisions based on national economic policy.

In section 2, I discuss how national differences in legal systems result in the unique behavior of Japanese enterprises. I do however refrain from making value judgments, including avoiding discussions regarding which shareholder primacy model or stakeholder

¹ Additional references for this section include Kinnyu, Shohin, Torihikihou & Kenkyuukai [2010], Shishido [2011], Shishido, Yanagawa & Osaki [2010], Miyajima [2011b], Milhaupt [2009], Kraakman et al. [2009], and Milahaupt & West [2004].

primacy model should be applied to Japanese enterprises. The sole purpose of this paper is to stimulate pragmatic discussions on how to reform the structure of Japanese enterprises' behavior.

There are several conditions necessary to conduct meaningful research on this topic. First, it is necessary to outline the relevant legal systems as a whole as they are divergent yet related. Second, I will describe not only the 'laws on the book' but also 'legal systems in practice' to analyze their influences on the actual behavior of the enterprises. Third, I will also offer a comparative analysis between Japanese legal systems and their foreign counterparts in consideration of the vigorous cross-border activity of enterprises and investors.

It will be difficult to satisfy these stringent conditions; indeed, an accurate analysis should be provided based on legal and economic studies. As a broad knowledge of academic theory and business practice is indispensable, it is beyond the scope of this paper to include such a discussion.

Therefore, I will not attempt to prove academic conclusions but rather aim to stimulate the interest of scholars and policymakers by presenting a paper that offers several points for discussion regarding this problem. In addition, I focus my discussion on the financial aspect of Japanese enterprises, an area where I have the comparative advantage of extensive expertise.

In this manner, I will research the possible influences of the legal systems that govern corporate finance on the behavior of Japanese enterprises and present several hypotheses. The laws discussed in this paper cover not only corporate law but also bankruptcy law, capital markets law and civil litigation law, disciplines that come under the umbrella 'enterprise law'.

In this paper, I wish perform a partial differentiation analysis on the Japanese economy to achieve the aforementioned purpose. The research design of this paper is as follows.

First, I identify differences in the major legal systems that I believe may influence the behavior of enterprises in Japan, the United States, and Germany.

Second, I assume hypothetical incentive structures of the parties concerned, such as shareholders, creditors, investors, regulators, and plaintiffs in lawsuits. Here I set the working assumption that they play their role on the basis of economic rationality. I also

assume that legal systems, including the lawsuit system, are used as tools and the court is a kind of marketplace for their economic transactions.

Third, I combine the aforementioned examinations so as to consider the possible effects caused by the differences in legal systems on the differences between the behavior of Japanese enterprises and their American and German counterparts.

Thus, I present several hypotheses concerning the legal backgrounds to the unique behavior of Japanese enterprises.

I also wish to concentrate my discussion on incentive bargaining between enterprises and outside monetary capital suppliers. Thus, I omit any discussions on the internal organizational design of enterprises, for example independent directors or external auditors. I simply regard Japanese enterprises as de facto 'company communities' and assume that the directors behave as if they were representatives of those communities. I believe this assumption is realistic enough because the directors of Japanese listed firms are generally ex-employees of the firm, their compensation system is not intensively correlated with the profits of shareholders, and directors' powers to dismiss employees are very restricted under the Japanese legal systems.

Based on this research design, the remainder of this paper provides the following discussions.

In section 3, I examine the legal systems concerning business reorganization such as bankruptcy law, mechanisms that deal with the responsibility of the directors of failed enterprises, and regulations governing the dismissal of employees. Here I discuss why Japanese enterprises might retain significant cash reserves to avoid the danger of being compelled to file for bankruptcy protection.

In section 4, I examine the legal systems concerning takeover bids in corporate law and market law, and discuss the balance between the takeover bidder and the management team of the target enterprise. I discuss here the possibility that a potential bidder might regard the takeover of a Japanese enterprise as irrationally difficult. I also argue the lower profitability and larger internal cash reserves of Japanese enterprises might be brought about via two channels, i.e., an insufficient reorganization of industry and weak market pressure on individual enterprises.

In section 5, I examine the legal systems concerning shareholders' activities such as

voting and the behavior of the so-called 'stable shareholders'. Here I show the possibility that dominant Japanese shareholders prefer individual benefits in their business relationships with enterprises rather than monetary returns as genuine financial investors. In addition, I suggest that Japanese legal systems such as disclosure regarding the corporate governance system may provide negligible pressure on enterprises and investors.

In section 6, I examine the legal systems concerning the enforcement of enterprise law, such as lawsuits by shareholders or actions by regulators. Here I state that the enforcement of capital market laws is weak and relies on regulators' actions, and that shareholders mainly employ derivative suits based on corporate law. Thus, I also show that these particular characteristics of enforcement could contribute to reduced market discipline and risk aversion in the business decisions of Japanese directors.

In the conclusion section of this paper, I restate the hypotheses put forward in the earlier sections and offer several remarks on Japanese enterprises and industry.

1 The behavior of Japanese enterprises and the capital market²

(1) Poor performance of Japanese enterprises

(i) Continuous decline in the profitability of Japanese enterprises³

The profitability of Japanese enterprises has been low for some time now and has declined further in recent decades.

The development of the return on assets (ROA) of Japanese enterprises is shown in Chart 1. Here I show the developments of the ratio of operating revenue per total assets of Japanese enterprises, sourced from the Ministry of Finance's 'Financial Statements Statistics of Corporations'. The ROA of the Japanese manufacturing sector has been in decline since the mid-1970s with fluctuations reflecting business cycles. The ratio of the non-manufacturing sector has been low since the end of World War II, and has declined further since the beginning of the 1990s. ROAs increased in the mid-2000s, especially in the manufacturing sector. However, these increases of profit were mainly attributable to cuts in labor costs and were transient.

It has been stated that the value added by enterprises is more important from the viewpoint of the national economy. According to this claim, such profit can be acknowledged as the distribution of an enterprise's total product to equity capital. Regarding this idea, Chart 2 indicates the development of the ratio of value added against the total assets of Japanese enterprises. The value-added productivity of the Japanese manufacturing sector steadily declined through the 1980s, 1990s, and 2000s. It shows a smooth curve without a hump in the 2000s. In contrast, the value-added productivity of the non-manufacturing sector in Japan has been relatively stable in the 1990s and 2000s.

Now let me turn to profit indicators—based on the main theme of this paper of corporate finance.

The next index of profitability is the return on equity (ROE). This ratio has also been quite low and has shown a greater decline than ROA since the mid-1970s. This trend is particularly remarkable in the manufacturing sector. Even during the business recovery

² An additional reference for this section is Kawakita [2012].

³ See Itami [2006], Kawakita [2010], Nakamura [2001], Mishina, Amano & Shimizu [2003], and Mizuno & Takahashi [2002].

period in the first half of the 2000s, the ROE of Japanese enterprises remained essentially the same.

This downward development of the ROE in Japan is due in part to the continuous rise of the capital per asset ratio (CAR). Chart 3 shows a sharp contrast in the development of CAR between the manufacturing sector and the non-manufacturing sector in Japan. The CAR of the non-manufacturing sector has enjoyed an upturn since the latter half of 1995. It is obvious that they have deleveraged their balance sheets to get rid of the legacy caused by Japan's bubble economy. In contrast, the CAR of the manufacturing sector has continually grown since the late 1970s. There appears to be no impact from fluctuations in the financial condition such as the bubble economy or financial crisis.⁴

Let me explain here why I use statistics regarding operating revenue and not the current income of Japanese enterprises. I do so because the interest rate during this period shows a declining trend in Japan and enterprises have shown continuous surpluses in their balance sheets. Therefore, statistics regarding the current income of Japanese enterprises have an upward bias. In this paper I want to identify the reason for the low profitability of their businesses.

These indicators suggest that the low profitability of Japanese enterprises, especially in the manufacturing sector, is a structural problem and has become more serious over time.

(ii) Comparison with US and European counterparts

In this section I make comparisons between the financial performance of Japanese enterprises and their US and European counterparts.

Chart 4 shows surpluses and deficits in the non financial corporate sector. The data are sourced from the document 'Flow of Fund Statistics' from the Bank of Japan and the equivalents in the US and Euro-zone. The corporate sector in Japan has continuously recorded a large surplus in their fund balance for the last two decades. The fund surplus of the Japanese enterprise sector increased significantly particularly in the second half of the 2000s, reflecting deleveraging in the non-manufacturing sector after the bubble economy. The surplus then declined in the mid-2000s, but remarkably increased again after the Lehman shock in 2008.

⁴ See Hasegawa, Akita & Masuda [2004].

As for the background to the fund balance surpluses of Japanese enterprises, it is claimed to be a natural response by management to the liquidity dry-up symptoms caused by financial crises (for example, the non-performing loan problem in the 1990s or the Lehman shock in 2008).

However, I strongly disagree with this claim because the responses of US and European nonfinancial enterprises to the impact of the Lehman shock did not result in a large and continuous cash surplus like Japanese enterprises. The US corporate sector showed a temporary surplus in 2009, but it was simply a temporary countermovement to the extraordinary crisis in 2008. The fund balance of the European corporate sector has been essentially stable, in spite of the continuous instability of its financial system (compared with Japan's relative stability). I regard the development of the US and European corporate sectors as normal, because the monetary capital of enterprises should be invested for business purposes according to the capitalism standard.

Chart 5 shows the striking contrasts in the financial behavior of Japanese listed firms compared with their US and European counterparts.⁵ The cash per market capitalization ratio of Japanese firms has been more than two times larger than that of the US equivalent. At the same time, the operational margin per total sales (OPM) of Japanese firms has remained about half that of US firms. The ratios of European listed firms moved from a similar level to Japanese firms at the beginning of the 2000s to that of the United States in the latter half of the 2000s. I believe that this transformation in the financial performance of European listed firms is worthy of close examination by Japanese scholars and policymakers.⁶

It is sometimes pointed out that the difference in the growth potential of enterprises in an individual country reflects the internal interest rate of the country's national economy. This difference should be adjusted to compare the net difference in the behavior of enterprises in different countries.

Chart 6 compares the developments of OPMs after the deduction of long-term interest rates in Japan, the United States and Europe. As for the European long-term interest rate, I employ the yield of German government bonds. The Japanese long-term interest rate has continuously recorded lower rates than US and German equivalents. However, the

⁵ See Kawamoto [2011].

⁶ See Kumagai & Aoki [2008] and Mizuno & Takahashi [2002].

discrepancy between the adjusted OPMs of the Japanese and US rates was still significant and currently amounts to approximately 4%. The exception is 2001, when the IT bubble collapsed in the United States. European-adjusted OPM showed a similar shift in the first half of 2000. However, a clear discrepancy emerged between Japan and Euro-zone in the latter half of the 2000s.

The combination of a rich cash reserve and poor profitability has made the price to book value ratio (PBR) of Japanese firms extremely low during this time. As indicated in Chart 7, the average PBR of Japanese listed firms on the Tokyo Stock Exchange has continuously remained below unity. The exception was the mid-2000s when labor costs were reduced because of institutional changes in the labor market. There is no significant difference between the first sector stocks and the second of the Tokyo Stock Exchange. With the exceptions of Italy, Russia, and Austria, it is currently difficult to find such a poor performance on the stock market elsewhere in the world. In addition, regarding the performance of individual stocks in Japan, I see that most listed firms (that is, those without any particular problems) on the Tokyo Stock Exchange also show PBRs less than unity. Thus, the real business activities of these listed firms in Japan are regarded as discounted factors from the viewpoint of investors.

These comparative statistics suggest that the reasons for the problems of Japanese listed firms are not only structural but also unique given the international standard. At the same time, attention should be given to the idea that German enterprises may have shifted away from Japan and are now closer to the situation in the United States.

(2) Market discipline on enterprises

Before beginning my detailed discussion on the reasons for the poor performance of Japanese enterprises, I will first confirm the basic theory regarding the relationship between corporate finance and the financial market.

Generally speaking, an enterprise is composed of not only personal capital providers such as management and employees, but also of financial capital providers such as shareholders and creditors. Shareholders (such as institutional investors) and creditors (such as banks) pursue their own economic interests. The management team of an enterprise must give certain priority to their interests; otherwise enterprises cannot raise the necessary funds from the financial market and must abandon their plans to continue business. Accordingly, management is disciplined by the financial market mechanism.

The effects of the market mechanism on corporate finance can be different between unlisted firms and listed firms because the information creation function for financial intermediation is essentially different between the banking system and the capital market system.

For the financing of unlisted firms, relationships with the banks are critical to overcome information asymmetry. This relationship is based on the information creation function of the banks, which by nature works locally, following the standard money and credit theory.⁷ Therefore, the behavior of mid-sized and smaller enterprises can vary between different countries.

However, the environment regarding the finance of listed firms is very different. This is because governments have established various infrastructures to ensure the integrity of information in capital markets. Based on the integrity of the market, the stocks of listed firms become objects of arbitrage investment by various investors. Especially in the global capital market, many and various enterprises raise funds competitively, and many and various investors want to achieve better performance by arbitrage investment in financial instruments issued by various enterprises. Thus, listed firms from all developed markets are under pressure to follow a common market discipline in their financial activities, even though they have diverged characteristics in their real business activities.

Despite this, Japanese enterprises, although listed in the globally open stock exchange, show remarkably low profitability in contrast to their US and European counterparts. This striking difference in financial behavior suggests that Japanese enterprises are influenced by some structural factors that reduce the influence of the capital market.

(3) Structural aspects regarding the low profitability of Japanese enterprises

(i) Economic analyses

There are several empirical analyses that can be used to determine the structural aspects of the low profitability of Japanese enterprises.

First, it is assumed that Japanese enterprises have lower profitability because they take fewer risks. For example, a study compared the profitability of individual Japanese enterprises with those in the United States and concluded that the variance in the ROA of

⁷ See Stiglitz & Greenwald [2003].

Japanese enterprises is far smaller than that of US enterprises.⁸ This study claimed that Japanese enterprises take fewer risks, although higher risk taking is essential to obtain higher returns. A further study concerning the risk-taking attitudes of Japanese enterprises conducted an empirical analysis of the ROA and its time variances of individual Japanese enterprises.⁹ That study concluded that an enterprise with a higher time variance tends to have higher profitability.

Second, a further study indicated that a lower capital cost is the reason for the lower profitability of Japanese enterprises.¹⁰ According to that study, investment and employment with low profitability occurred because enterprises enjoyed lower capital costs.

I am not totally satisfied with the above explanations as contributions to policy planning because they convey to economic policymakers that low profitability occurs because of incurable reasons.

(ii) Demographic issue

This low profitability and low potential of growth has been frequently explained in the context of Japan's demographic issues. It is claimed that the potential growth rate of Japan is in decline because the labor force is decreasing and/or the aging population is a significant burden on the social security system. In addition, it is often introduced as good evidence for this hypothesis that survey data regarding the demand growth expectation of enterprises is highly correlated with the statistical data showing the fixed asset investment per cash flow of enterprises.

However, I strongly resist such pessimistic fatalism for the following reasons.

First, the decline in Japanese enterprises' profitability began before Japan's aging population became a problem. As explained above, the ROA of Japanese enterprises has been in decline since the mid-1970s, when the labor force ratio in Japan's population showed a higher growth rate than other industrialized countries.

Second, Germany offers a counter example. German enterprises have shown a remarkable improvement in their profitability in recent years. Although Germany faced

⁸ See Itami [2006].

⁹ Kameda & Takagawa [2003] and Cabinet Office [2008].

¹⁰ Cabinet Office [2006].

similar problems with an aging population, they overcame the declining effects. Regarding this contrast of behavior between Japan and Germany, I wish to introduce an analysis that shows that the policy initiative to slash unit labor costs and encourage cross-border investment has vastly improved the profitability of German enterprises.¹¹

(iii) The culture of enterprises

The so-called 'Japanese way of management' is frequently claimed to explain the long-term nature of Japanese enterprises, which is often connected with the tolerance of their low profitability. Japanese enterprises value their 'regular employees', promote their life-long seniority system, and are supported by so-called 'stable shareholders'. These characteristics were traditionally praised as the key to the 'Japanese economic wonder' and some Japanese management still consider it a valuable tradition for Japanese enterprises.¹² However, it is easy to find many critics, especially in the form of foreign scholars.¹³ They argue that this 'Japanese way of management' is a barrier to essential, rapid reform that responds to the quickly changing business environment. It is also thought to be an obstacle to risk taking, which is necessary to achieve higher profitability.

I will refrain from participating in this long-held discussion, which can only lead to value judgments.

The purpose of this paper is to contribute to the discussion regarding appropriate policy choices to help the Japanese economy overcome its current stagnation. I will not depend on a cultural explanation such as 'Japanese way of management'. In contrast, I want to identify factors that can be reformed by policy measures based on economic rationality, even if they are only one aspect of many influential reasons. To this purpose, from an economic viewpoint, I will focus my discussion on the various influences on the behavior of Japanese enterprises.

(iv) Suggestion from foreign direct investment statistics

I believe that the Japan's foreign direct investment (FDI) holds a clue to answering this question.

¹¹ See Kumagai & Aoki [2008].

¹² See Arikawa et al. [2006].

¹³ For example, see Anchordoguy [2011].

As indicated in Chart 8, Japan's ratios of FDI per GDP (gross domestic product) are extremely low. There may be a tendency for these ratios to be lower in larger economies. However, Japanese ratios are remarkably lower than those of the United States, and therefore there must be a reason for this difference.

The ratio for inward FDI in Japan is extraordinarily small compared with other industrialized countries. In addition, there is an extreme imbalance between outward and inward FDI. There may be a tendency that inward FDI is smaller than outward FDI in industrialized countries. However, the imbalance FDI in Japan is significantly large; again, there must be an explanation for this situation.

The flow-base statistics of direct investment essentially show the same imbalance, although they also show large fluctuations.

Chart 8 indicates the estimated rates of return for outward FDI in Japan, the United States, and Germany. The US rate has been higher than the others, probably because of the accumulation of concessions over many years. However, it is important from the perspective of this paper to note that until recently the Japanese ratio was similar to the German ratio, in contrast to the ratio of OPM of listed firms shown in Chart 5. This trend could be explained by stating that Japanese enterprises perform similarly to foreign enterprises outside of Japan. The low profitability of Japanese enterprises may be caused by domestic environments that are different to those in other countries.

Therefore, it is necessary to look at the problems experienced by businesses in Japan to identify concrete obstacles to inward FDI. It is likely that some of these problems are not recognized by Japanese businessmen as they are so familiar with such conditions. Thus, the impressions of foreign investors are more relevant here.

Chart 9 shows the obstacles facing foreign enterprises in Japan, as identified in a survey by the Japan External Trade Organization in 2008. The first obstacle facing foreign enterprises in Japan is the difficulty to employ staff with appropriate skills. The second is high business costs. The combination of taxes, social security contributions, electricity prices, and other business expenses contribute to high business costs in Japan. The next two obstacles concern relationships between enterprises. It must be noted that governmental complications such as regulations or administrative procedures are less of a burden than the aforementioned obstacles. It should also be noted that the shrinking market is not viewed as an obstacle for foreign enterprises. The results of this survey suggest that the business practice of Japanese enterprises and their employees are the main obstacles for foreign

enterprises that wish to invest in Japan.

Based on these considerations regarding FDI, the basic premise of this paper is that Japanese enterprises are less profitable because of the unique structural factors governing business practices in Japan.

I believe that the legal systems surrounding Japan's enterprises are promising candidates as one of the reasons for these unique factors. There are obviously various factors (for example, a shrinking labor force and Japan's unique business culture) that come into play and result in the low profitability of Japanese enterprises and a stagnant Japanese economy. However, the legal systems that direct Japan's enterprises also have a significant influence on their behavior. Thus, I believe that it is essential that the legal systems be reformed based on economically rational policy decisions.

2 Framework of the research

(1) The law and economics governing Japan's enterprises

The effect of legal systems on the behavior of enterprises is one of the most important subjects for both legal and economic sciences. There are vast amounts of literature on this topic, from comparative analyses of corporate law by jurists to the principal agent theory by economists.

Among them, I believe the law and economics theory is the most useful for this paper. The transaction costs theory in particular is the most suitable to illuminate the problem of Japanese legal systems. Based on this theory, I wish to examine the effects of legal systems on the actual behavior of Japanese enterprises to further contribute to the policy discussion.

In the field of legal science, attention should also be given to the concept of 'enterprise law'. According to literature regarding this idea, an enterprise is the bargaining mechanism among human capital providers (such as management and employees) and monetary capital providers (such as shareholders and creditors). Enterprise law is defined as any law that influences the incentive bargaining of the enterprise. The concept includes a wide range of legal systems, not only statutory corporate law but also securities law, bankruptcy law, judgments, and contracts. These laws do not themselves influence the incentive bargaining of the enterprises, rather they influence the inter-relationships between enterprises and markets.

In this paper I will refer to many related articles written by various authors including scholars, jurists, economists, policy-makers, and businessmen. In this sense, this paper can be viewed as a survey paper.

(2) Research design

(i) Necessary conditions for effective research

From the aforementioned concept, I must follow several necessary conditions to execute meaningful research into the influence of legal systems on the behavior of Japanese enterprises.

First, the analysis must cover all aspects of the financial behavior of enterprises. The influences of legal systems on enterprises' activities are closely connected. For example, the

effectiveness of the protection of shareholders in corporate law will have little influence on the behavior of enterprises if enforcement mechanisms, such as shareholder lawsuits, are not effective. Therefore, I will embark on a bird's-eye view of Japan's legal systems that influence the financial behavior of Japanese enterprises.

Second, I must examine not only 'laws on the book' but also 'legal systems in practice'. For example, the management body of an enterprise does not typically consider a law that is not usually applied in business practice. For them, the actual pros and cons of the legal systems in practice are crucial. The intention of the lawmaker does not directly matter in actual business.

Third, I will compare Japanese legal systems with foreign equivalents, which could be appropriate alternatives for enterprises and investors. I demonstrate that enterprises typically conduct their cross-border business activities quite vigorously, and how international investors build up their portfolios in the global capital market.

(ii) A law and finance approach to the behavior of Japanese enterprises

Under the aforementioned stringent conditions, the only realistic possibility to contribute to the discussion on the behavior of Japanese enterprises is by way of a differential analysis of enterprise law.

Therefore, I will begin by identifying the significant differences in enterprise law in Japan and other countries. I will then infer the possible effects of such differences, working on the assumption that the concerned entities act in an economically rational manner. To follow, I will determine if the possible effects are consistent with the actual differences between Japanese enterprises and their foreign counterparts.

First, I compare the law mechanisms of the United States and Germany with those of Japan. Both the United States and Germany have many enterprises whose stocks are the objects of global arbitrage investment; therefore, the influence of the differences in legal systems on the difference in the behavior of enterprises is worthy of study. Germany, in particular, shares similarities with Japan, such as legal origin, past behavior of enterprises, and current demographic issues. However, the profitability of German enterprises has grown and Japan's have not.

Second, I will select which legal systems will be examined in this paper. I believe the following will be appropriate: bankruptcy protection for business reorganization, takeover

regulations, the legal environment for shareholder activities, and the enforcement system under enterprise law. These legal systems correlate with cash holdings and hence the risk-taking behavior of enterprises that is essential to obtain profit. I will provide detailed reasons for these choices later in the paper. As it is impossible in this paper to cover all relevant laws, I will omit tax laws, fair competition laws and regulation laws on individual industries, despite the possibility that they too influence the activities of enterprises. As stated previously, my aim is that paper focuses on the financial behavior of Japanese enterprises.

Third, I presume that the concerned parties, such as directors, shareholders, creditors, investors, and regulators, have incentive structures based on economic rationality. According to this working assumption, they use legal measures as tools for their business transactions and the courts are used as market places for transactions that cannot be cleared via price mechanisms. In addition, their everyday business decisions are influenced by the backward counting of a possible solution for the dispute. That is, the parties suppose possible disputes with their business partners, then they decide whether to file a legal procedure taking into account the relative costs and benefits based on the related legal systems. This conceivable decision then becomes the major premise of their bargaining in business, and the expected results of this bargaining would become the references for their everyday business decisions.

Fourth, I combine the actual differences in enterprise law and the presumed incentive structures of the parties, so as to provide the expected effects of the differences in legal systems on the different behaviors of enterprises. I will then compare these expected effects with the reality of Japanese enterprises. If they are consistent, I will present them as hypotheses for further research.

The hypotheses can be presented to explain the low profitability of Japanese enterprises. I believe that this work can provide the basis for further research by scholars and will be of value to policymakers, even if I cannot fully prove that these mechanisms influence the actual activities of Japanese enterprises.

This paper contains an important caveat, that the reverse causality may also apply; that is, that the unique behavior of Japanese enterprises might influence the law-making processes so as to form Japan's unique enterprise laws. Despite my agreement with this claim, I will not examine it in this paper due to space constraints. I hope that this theory can be analyzed in the future from the viewpoint of political economics.

(3) Determining the scope of research

As stated above, the main issue in this paper is to determine why Japanese enterprises have low profitability and rich cash reserves. I will concentrate my discussion on the incentive bargaining between enterprises and outside monetary capital suppliers. Therefore, I will omit any discussions on the internal organizational design of enterprises, such as the board of directors or auditors. In this paper I simply regard a Japanese enterprise as a de facto 'company community' and assume that the directors behave as if they were representatives of these communities. I presume that this assumption is accurate enough for the following reasons.

First, the directors of Japanese listed firms are mostly ex-employees of the firms. According to a 2011 survey by the Japan Association of Corporate Directors, only 1,700 outside directors exist among the 15,000 directors of listed firms in the first section of the Tokyo Stock Exchange.¹⁴ However, most of these outside directors are affiliated persons such as ex-employees of the business partners or advisory attorneys.¹⁵ Moreover, a further study stated that they were assigned not for the benefit of shareholders but for the benefit of insider directors.¹⁶

Second, the compensation system of Japanese directors is not strongly correlated with the profit of shareholders. Incentive mechanisms such as stock options to encourage the directors to maximize shareholders' profits are seldom employed in Japanese listed firms.¹⁷

Third, directors' powers to dismiss employees are strictly restricted in Japan. According to precedents regarding the abuse of employment dismissal procedures, management must satisfy four conditions before dismissing an employee. If these conditions are not satisfied, the dismissal is deemed void as it is regarded as an abuse of the right of dismissal. The conditions are as follows:

- Necessity of redundancy of employment
- Efforts to avoid dismissal
- Fair selection of individuals to be dismissed
- Prior explanation to the employee and consultation with labor union

The condition regarding efforts to avoid dismissal is particularly strict for the management

¹⁴ See Japan Association of corporate directors [2011] and Miyajima et al. [2004].

¹⁵ See Saitoh [2011].

¹⁶ See Kawamoto [2009].

¹⁷ See Kubo [2010], Nakazato, Ramseyer & Rasmussen [2006] and Sho [2003].

body, as other alternatives must be offered, including salary reduction, transfer, and voluntary redundancy. In addition, the condition of the necessity of dismissal is not regarded as a business decision issue and is substantially assessed in detail by the court.¹⁸

Fourth, there is no established market for directors and employees outside of enterprises in Japan. They are locked into their particular enterprise for the span of their career.

¹⁸ See Ohtake & Fujikawa [2001].

3 Business Reorganization

(1) Issues for discussion

Japanese enterprises currently have rich cash reserves, which produce little profit under Japan's extremely low interest rates. The first issue for discussion is why do Japanese enterprises hold so much cash?

Economic theory tells us that an enterprise with rich free cash flow and few business opportunities is likely to invest its cash in unfavorable projects.¹⁹ According to this theory, it is efficient for an enterprise to pay out surplus free cash as dividends or stock repurchases for shareholders. This theory also tells us that an enterprise should raise funds by borrowing if a profitable business opportunity arises.

For some reason it appears that this theory is not applied in Japanese enterprises. According to a comparative study on the financial behavior of enterprises in various countries, Japanese enterprises have greater liquidity in their assets and lower dividend payout ratios than foreign enterprises.²⁰ In addition, many economic analyses on dividend policy argue that a 'stable dividend' makes common sense among Japanese listed firms.²¹ They point out that Japanese listed firms tend to maintain their dividend level during slump periods and they do not increase their dividends during times of growth. It is also argued that stock repurchases in Japan are generally used by less leveraged enterprises to return just a small part of their free cash to shareholders.²²

Thus, there is extensive literature that demonstrates that Japanese enterprises tend to retain high levels of internal reserves against free cash flow. They should manage their cash flow more flexibly to achieve better efficiency under the current stable financial system and extremely easy monetary conditions in Japan.

(2) Incentive structure of parties related to business reorganization

(i) Cash reserves against failure of payment

¹⁹ See Jensen [1986].

²⁰ See Oinkowitz, Williamson & Sturz [2007].

²¹ See Suwabe [2006] and Niiya et al. [2007].

²² See Hirose, Yanagawa & Saitohu [2003].

Generally speaking, the cash demands of an enterprise are decided by various factors. In the case of one with less profit opportunities, the most likely reason for the reserve is to avoid the failure of payment. Every business is subject to the risk that they will fall into deficit. However, it does not necessarily mean that an enterprise will fail if such a risk is realized as enterprises keep cash reserves as a safe guard against failure of payment.

However, an enterprise's management body must also make business decisions. If an enterprise only aims to minimize risk via cash management, it would surely miss the opportunity to make profit for the business.

An enterprise decides its cash reserve levels following a balance between the need to safeguard against failure of payment and the needs for fixed investments via business opportunities. If the risks of chosen project are realized, then the enterprise may need to reorganize its business model.

(ii) Incentive structure of parties concerned

When lending funds to enterprises, creditors normally include a provision covering the expected loss, and that loss becomes a sunk cost before the enterprise fails. Therefore, creditors try to minimize any additional losses beforehand by withdrawing cash or the foreclosure of collateral. Both actions may compel the enterprise to stop trading. In contrast, the creditor may want to decrease the amount of the provision by cooperating with the business reorganization of the distressed debtor. The choice between withdrawal and cooperation depends on the expected loss between liquidation and reorganization.

However, creditors have little information about the possibility of restructuring the enterprise, and therefore the first offer of business reorganization should be made by the debtor. The incentive structure of an individual creditor depends on many factors such as the collateral or business relationship. Therefore, it is not easy to reach agreement on a particular reorganization plan when there are many creditors.

Shareholders can recognize the expected loss of a distressed firm by means of a decline in the stock price; that loss becomes a sunk cost for them. Shareholders have the incentive to let the firm take additional risks to recover from the distressed situation. Especially in the case of deep distress, this incentive becomes one-sided, with shareholders preferring high-risk projects. As shareholders can take all the profit in the case of a success, additional losses will be borne by creditors in the case of failure. This is a moral-hazard problem.

From the viewpoint of the management body and employees of a distressed enterprise, the expected loss is not a sunk cost. They compare the pros and cons of business reorganization including implementing a bankruptcy procedure, the possibility of reconstructing the enterprise, and suffering from loss realization. If the threat from the latter is regarded as greater than the chance of the former, they have the incentive to postpone the start of reorganization.

(iii) Bankruptcy protection

It takes a certain period to formulate a feasible business reorganization plan. The enterprise must continue to pay its bills to keep the business going during this period. However, the enterprise is not sure if cash management is possible until the compilation is complete and if the creditors cooperate with the effort. Therefore, the enterprise must bring the possibility of the bankruptcy procedure into view, by which it can obtain bankruptcy protection and a majority decision for the reorganization plan.

A bankruptcy procedure means the accrument of the expected loss for creditors as well as a shift in power from shareholders and management to creditors and receiver or conservator (hereafter administrator for both scenarios). This is a form of realization as stated in the residual claimant theorem. In many cases, the creditors of a bankrupt enterprise have certain losses on their lending. Therefore, they want to compel the management body and employees to share the realized loss.

This incentive of the creditor yields a serious threat for the 'company community' of the distressed enterprise. However, it strongly depends on concrete bankruptcy mechanisms. Under a rigorous bankruptcy mechanism, a distressed enterprise has a strong incentive to avoid the bankruptcy procedure and to start business reorganization. The loss generally becomes larger if there is a delay in starting business reorganization. In the case of postponed business reorganization, the economic penalty for the human capital providers will be more serious. This represents a vicious circle.

The most plausible measure for an enterprise to avoid business reorganization is building a strong cash reserve. In other words, cash reserves and bankruptcy protection are two alternatives for a distressed enterprise. As the management body of an enterprise counts backward from this substitution, as they do in everyday business, a rigorous bankruptcy mechanism presses them to dig a deeper trench by having greater cash reserves.

Thus, an enterprise's cash reserve reveals a preference for entrenchment influenced by

the balance of pros and cons of starting business reorganization. Of particular importance is the possible penalty against the management of the bankrupt enterprise.

(3) Comparison of business reorganization in bankruptcy

(i) Recent developments in Japan

Japan's business reorganization system has undergone sweeping changes since the late 1990s to overcome its non-performing loan problem. First, the Civil Rehabilitation Law was introduced in 2000, followed by 'The Guideline concerning the Out-of-court Workout', established as a soft law, in 2001. The next steps included comprehensive amendments the Bankruptcy Law in 2005 and the Corporate Reorganization Law in 2006.

These measures resulted in the fundamental reform of Japan's bankruptcy procedure, shifting from a traditional disposal system of failed enterprises centered on the dishonor and foreclosure of collateral to a business reorganization system led by the active participation of all concerned parties.

The debtor in possession (DIP) procedure, which was introduced by the Civil Rehabilitation Law, has had a significant effect in reducing the obstacles for management to start the legal reorganization procedure. This procedure was introduced to accompany the Corporate Reorganization Law by the Tokyo district court.

Accompanying this reform, the liquidation procedure of the Bankruptcy Law is now being used for the purpose of business reorganization. For example, if the reason for an enterprise's distress lies with the founders' family, the liquidation of their equity and the transfer of operation from them to the sponsor are more effective for business reorganization than the reconstruction procedure.

(ii) Requirements to file for bankruptcy procedure

There is a remarkable difference between Japan, the United States, and Germany in their requirements to file for bankruptcy protection (see Chart 10). In the United States, the Chapter 11 procedure states no specific requirement for the debtor to file except the general principle of 'uberrima fides'. Germany has a similar requirement of 'insolvency or default and their likelihood' in the Insolvency Act ('Insolvenzordnung'), as does Japanese law. However, there is a critical difference between Germany and Japan. If a debtor is insolvent but can pay, he must file for bankruptcy in Germany, while he may or may not choose to file

in Japan. The German debtor can be punished criminally and is liable to creditors.²³ All filed bankruptcy documents are assessed by public prosecutors in Germany, although the definition of insolvency was eased somewhat after the global financial crisis.²⁴

This comparison shows that the incentive equilibrium regarding the decision to file for bankruptcy is balanced in the United States and Germany but asymmetric in Japan; incentive balances remain in the United States and Germany, albeit the methods to maintain equilibrium are quite different. However, in Japan, the incentive balance is basically one-sided. Given the incentive structure explained above, Japanese bankruptcy laws induce a distressed debtor to postpone the filing of the bankruptcy procedure and to engage in business reorganization as long as he can pay expenses.

(iii) Threat to management

In addition to the requirements for bankruptcy protection, the various threats to management and employees by the related mechanisms could influence the incentive balance between bankruptcy protection and entrenchment by cash reserve.

The first threat to the management body of a distressed enterprise is the loss of initiative in the enterprise.

In this regard, in the United States, the DIP procedure is popular and pre-packaged reorganization plans can be employed under the Chapter 11 procedure.

In Germany, 'Insolvenzordnung' was introduced in 1999 as a consolidated bankruptcy law for both the reconstruction and liquidation of an enterprise. The DIP procedure is allowed under this law, but the power of the judges over the bankruptcy procedure was too strong for debtors and major creditors to widely use the DIP system. This was seen as a clear disadvantage for German industry in the European Union. Thus, Germany made substantial amendments to the 'Insolvenzordnung' with the 'Law for the further Facilitation of the Restructuring of Companies ('Das Gesetz zur Erleichterung der Sanierung von Unternehmen'). The important points of this reform enhance the initiative of entities wishing to proactively utilize the legal procedure.²⁵ For example, the law strengthened the power of creditors' commissions to encourage enterprises to adopt the pre-packaged

²³ See Yoshihara [1985] and Urakawa [2011].

²⁴ See Bewick & Schlegel [2013].

²⁵ See Graf-Schrecker [2012] and Nomura Institute for Capital Market Research [2011].

reorganization plan under the planned administrator including the DIP.

In contrast, Japan has halted its reform to enhance the initiative of management to start business reorganization at an appropriately early stage. Japan has now excessively enlarged its governmental guarantee concerning lending by financial institutions to small and mid-sized enterprises.

The next threat to management is that they might be held responsible for the enterprise's distress.

In this regard, Japan has a unique clause when management has engaged in intentional damage or gross negligence. In such a situation, before the enterprise fails, the creditor must state to a third party that the responsibility of the distress falls on the management body.²⁶ The United States does not have this kind of clause,²⁷ and while Germany has something similar, the concept is different. In Germany, a debtor in distress is obliged to determine without delay whether the enterprise is insolvent. The third party responsibility clause works in Germany as grounds to lay the responsibility with management.²⁸

Moreover, criminal impeachment by a prosecutor is considered to have had a serious negative impact on the incentive of Japanese management bodies to file bankruptcy proceedings. The trigger that started the sweeping reform of Japan's bankruptcy system was the financial crisis in the late 1990s. At the time that an extraordinary measure to protect all liabilities of financial institutions via a fiscal fund was introduced, a clause was also included in the Financial Rehabilitation Law to obligate the government to lay civil and criminal responsibility with the management of failed financial institutions. This clause was seen to reflect public opinion at that time. Following that clause, the Tokyo Public Prosecutors' Office executed its so-called 'investigation under the national policy' and charged the directors of the Long Term Credit Bank of Japan and the Nippon Credit Bank for dressing financial reports. Although the directors were not convicted, the criminal cases took more than 10 years to reach their conclusion. These affairs have been an extremely bitter lesson for Japanese directors.

(iv) Threat to employees

²⁶ See Tanak [2006].

²⁷ See Gotoh [2010].

²⁸ See Urakawa [2011].

The employees of a distressed enterprise are generally fearful of dismissal. The threat of dismissal that accompanies the start of business reorganization differs among Japan, the United States, and Germany.

Japan places tight restrictions on the dismissal of regular employees. As mentioned above, the dismissal procedure used to dismiss an employee for business reasons is void unless four conditions are satisfied. Among the four conditions, the second (execution of duty to avoid dismissal) is especially difficult to satisfy. The enterprise must look at all possible alternatives such as employee restructuring, transfer, and offers of voluntary redundancy. As working conditions in Japanese enterprises are generally flexible in terms of modification, there are numerous alternatives that enterprises can explore.

This restriction lessens once the bankruptcy procedure begins. Thus, the filing of a bankruptcy procedure substantially increases of threat of dismissal for employees.²⁹

In sharp contrast, the United States has the ‘employment at will’ principle. Employees of a distressed enterprise fear dismissal regardless of whether the bankruptcy procedure has started. Therefore, in the United States there is not such a sharp imbalance of incentive in filing for bankruptcy as in Japan.

Germany has similar restrictions to Japan regarding dismissals for business reasons with a law that offers employees certain protection against dismissal (‘Das Kündigungsschutzgesetz’). However, in Germany the condition of the necessity to reduce personnel is regarded as a business judgment issue, whereas in Japan it is largely assessed by the court. In addition, Germany has enlarged the compensation of the dismissal (‘Abfindungsgeld’) system as part of its labor market reforms in the 2000s. With this system the directors of a distressed enterprise can pursue business rationality in the reduction of personnel. Thus, for employees the sudden increase in the threat of dismissal that accompanies the filing of bankruptcy proceedings is mitigated in Germany.

(v) Statistics regarding bankruptcy filings

The aforementioned difference concerning the bankruptcy system is responsible for a remarkable difference in the number of bankruptcy filings among the three countries as indicated in Chart 11.

²⁹ See Araki [2012].

In the United States, 5,000–10,000 cases are filed annually seeking the Chapter 11 procedure. The abuse of the procedure has been reduced by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Insolvency law in Germany is a unified procedure for both reconstruction and liquidation. Approximately 20,000 proceedings are filed annually.

In Japan, only 10,000 applications are made regarding bankruptcy procedures; a large number of these are liquidation procedures under the Bankruptcy Law. As for reconstruction procedures, as little as 500 are filed annually, with the exception of the years following the introduction of the law. Considering the comparative size of the Japanese economy, Japan has only one third of the number of German bankruptcy applications.

In this regard, the assessed loss for unsecured credit in civil rehabilitation procedures has been reported as being extremely low in Japan. According to a survey by the Medium and Small Enterprises Agency, approximately 90% of the rehabilitation plans compel creditors without collateral to give up more than 50% of the value of their credits.

In contrast, recent 2012 reforms in Germany have been reported as already having positive effects on the earlier implementation of business reorganization. According to a survey by a German law firm, approximately 40% of applications by enterprises under the new bankruptcy mechanism stated surpluses on their balance sheets, therefore seeking a debt/equity swap.

(4) Effects on the behavior of enterprises

As explained above, compared with those in the United States and Germany, Japanese bankruptcy mechanisms provide a weaker inducement to start business reorganization earlier. In addition, management and employees in Japan face an increase in threats with the filing of the bankruptcy procedure compared with the other two countries.

This condition provides a strong incentive to the management bodies of enterprises to avoid filing bankruptcy applications while they can. In Japan the management bodies of insolvent enterprises are not obligated to file a bankruptcy application, as long as they can meet the enterprise's bill payments. Thus, the cash reserves of Japanese enterprises work as a kind of entrenchment to protect the company community from the pressure of creditors.

Based on the discussion above, I present a hypothesis that the weak incentive for the

early filing of a bankruptcy application and the significant increase in threats that accompany the filing for bankruptcy may influence the behavior of enterprises, and thus they accumulate larger internal cash reserves.

4 Takeovers³⁰

(1) Issues for discussion

Economic theory tells us that an enterprise having excessive free cash flow increases the risk of a takeover bid. Therefore, even if Japanese enterprises wanted to build up entrenchments of internal cash reserves to protect themselves against bankruptcy procedures, they are also obliged to invest free cash into promising projects or to pay it out via dividends or stock repurchases. Particularly in the case of listed firms, as those stocks are always on sale in the market, anyone can purchase them. As the agents of shareholders, directors should not reject an increase in the demand for the stocks of the enterprise they represent.

In contrast, a takeover is the predominant infrastructure for M&A. Although it does not always succeed, the possibility of the occurrence of a hostile takeover bid works as a backstop for the negotiation of M&A. M&A is an important channel for an enterprise to obtain a better position in the industry. M&As are also crucial for the efficiency of economies of scale and synergy realized through consolidation.

Japanese enterprises hold rich cash levels despite their low profitability, even if listed on the stock exchange and engaged in internationally competitive businesses. However, movements towards takeovers in Japan, especially hostile ones, are relatively rare. Why is this? There must be a unique structural reason in the related institutions that goes beyond a simple economic explanation.

(2) Incentive structure of parties concerned with a takeover

(i) Takeover bidder

There are generally two types of potential takeover bidders.

The first is a strategic bidder. An enterprise that wants to expand its business line can save time by consolidating with another established enterprise in that field. The motivation

³⁰ Additional references for this section are Kariya [2012], Kigyokatikenkyukai [2008], Institute for Monetary and Economic Studies of BOJ [2010], Fujiki, Mogi & Tanino [2011], Baum et al. [2010], Buchanan & Deakin [2007], European Capital Market Institute [2012], Falkenhausen, Kocher & Watanabe [2010], and Fujita [2011].

for the strategic bidder is economies of scale or the synergy effect.

The M&A is normally decided via friendly negotiations between the directors of both enterprises. However, this negotiation does not always result in an easy agreement. The possibility of a hostile takeover is indispensable as a backstop. In other words, it is essential to inspire industry reorganization. Thus, directors negotiate under the shadow of the hostile takeover.

The second bidder is the financial bidder. The strategic bidder finds it difficult to identify an appropriate partner in a timely fashion and to reorganize its business and finance structure. It is here that financial intermediaries, such as private equity funds, come into play. They are important catalysts to stimulate the M&A. They purchase target firms and sell them to investors or strategic bidders after the necessary restructuring has occurred. They look for enterprises that can be restructured so as to improve performance. In extreme cases, they strip the assets from the target firm, termed vulture capitalism.

Takeovers are not always successful but they are the predominant modus operandi for M&A, which is crucial for the efficiency of the entire industry.

(ii) Target enterprise

The shareholders of a target firm have to decide if they will accept the offer from the bidder. They compare the offered price and the benefits they will enjoy from holding the stocks, such as future monetary gains and the business relationship with the issuer.

Therefore, the bidder tempts the shareholders by proposing an attractive price and by allaying their concerns about conditions if he would take the majority. So that the bidder is better prepared than the existing shareholders, it is advantageous for him to confidentially collect shares and to offer the bid on short notice.

In contrast, the directors of the target enterprise tend to be wary of the takeover bid, as they may be under tighter control by the shareholders and hence their position could become unstable. In addition, employees may also have concerns about changes in management policy after the control shifts to the takeover bidder. Therefore, in general the management body will attempt to persuade existing shareholders not to sell their stocks to the takeover bidder, insofar as the bidder does not offer them better treatment than the current one.

If the negotiation between the takeover bidder and the management body of the target enterprise breaks down, the takeover may become hostile. In the case of a hostile takeover, the shareholders make up their minds under pressure from both sides. They need enough time to at least consider the pros and cons of the bidder's offer. Shareholders need to be careful they are not blindly swayed by the persuasive offer of purchase or by the fear of retribution from management should the takeover fail. Of particular interest to minority shareholders is whether the offered price is advantageous for them.

In addition, shareholders should not relax their vigilance even in the case of a friendly takeover because there is always the possibility of collusion between the directors and bidder. If so, they may be sacrificed by the enterprise's directors so that they can obtain private benefits promised by the bidder.

(3) Recent developments in the takeover system in Japan

(i) Recent increase in takeover rates in Japan

Since the late 1990s, various structural reforms have occurred to improve Japan's economy. Amendments to various legal systems related to takeovers have played an important role in these institutional reforms.

Until the mid-2000s deregulation and legal amendments encouraged takeovers. For example, the Corporate Law had been amended to allow the exchange of stocks and the triangle merger of companies, and thus enable the cross-border takeover of domestic and foreign enterprises by offering their own stocks as consideration. Market laws were also amended to introduce consolidated and current-value accounting, enabling potential takeover bidders to examine the present value of target enterprises without worrying about hidden loss. Partly thanks to these reforms, the number of takeovers substantially increased in Japan in the mid-2000s.³¹

However, events such as the Livedoor scandal in 2006 drastically changed the atmosphere. These events triggered a public call to reorganize the related mechanisms to prevent the problems caused by hostile takeover bids, both in market law and corporate law.

(ii) Amendment of Financial Instruments and Exchange Law

³¹ See Arikawa & Miyajima [2007].

First, the regulation regarding reports on large shareholders was strengthened.

To follow, the regulation governing the takeover bid system was tightened as follows.

- A mandatory offer system was introduced for takeover bids that seek more than two-thirds of total stock
- An obligation to express opinions and the opportunity to question were given to target enterprises
- The time limit for the application to bid was extended
- Alteration of the bid in response to takeover defensive measures was allowed

(iii) Application of Corporate Law

In contrast to these reforms, the Ministry of Justice and the Ministry of Economy, Trade and Industry published in 2005 'A guideline for takeover defense measures to preserve the common interests of enterprises and shareholders'. The ministries stated that this guideline aimed to prevent excessive defensive measures against takeover bids and to improve the rationality of anti-takeover measures so as to formalize a fair rule for takeover bidders and enterprises.

This guideline indicated three principles for acceptable anti-takeover measures as follows:

- Maintain and improve the common interest of the enterprise and shareholders
- Prior disclosure and in accordance with shareholders' will
- Necessity of correspondence regarding anti-takeover measures

This guideline provided the way for anti-takeover measures; in response, many Japanese listed firms introduced measures in 2006. The majority of enterprises targeted by activist investors introduced anti-takeover measures in that year.³²

In 2007, the Supreme Court delivered its judgment on the Bulldog Sauce case. In this case, the Bulldog Sauce Company had issued an equity warrant as an anti-takeover bid measure with prior consent given at a shareholders' meeting. However, management did not give the warrant but rather money to the bidder and new stock to other shareholders. The bidder then filed a lawsuit claiming that the target enterprise's actions were against the principle of equal treatment of all shareholders. In this judgment, the Supreme Court

³² See Takizawa, Tsuru & Hosono [2010].

indicated that the use of the anti-takeover measure must be ultimately decided at a shareholders' meeting, to whom the interest of the enterprise belongs in the end.

(4) Comparison with US and German legal systems

(i) Basic concept of takeover regulation

The fundamental purpose of the regulation is the protection of the minority shareholders of the target enterprise, in consideration of the aforementioned incentive structures of the parties concerned (see Chart 12).

Therefore, information regarding the possibility of takeover bid must be given to market participants with a sufficient lead time. The regulation requires a report on large shareholders.

In addition, there are two strategies for the regulator to achieve this target. The first perceives the takeover as the collective transaction of stocks, with the priority being the integrity of the market by ensuring transparency and compelling related entities engage in fair play. The second strategy perceives the takeover as the shift of the target enterprise's right of control so that the priority becomes the right of the minority shareholders to exit by ensuring appropriate compensation available to them. From this point of view, two issues are crucial for lawmakers when designing the legal mechanism. The first is a mandatory bid rule that states that is the duty of the bidder to purchase all offered stocks or tender offer, which requires transparency and fairness. The second is the duty of neutrality, characterized as the duty of the directors in response to the offer or a special duty as the agent of existing shareholders.

(ii) The regulation of the takeover bidder

In the United States, there are two types of legal systems concerning takeover systems, state corporate law and federal security law. State corporate law provides for various anti-takeover clauses. In contrast, federal laws give the regulator a broad authority as a rule maker. If the bid is regarded as a regulated action by the authority, the bidder is obliged to employ the tender offer system. The bidder must then make sufficient disclosure in the market and treat all counterparts as equal. However, he need not obey the mandatory bid rule to make the offer to all the shareholders of the target enterprise. In addition, the bidder can alter the conditions of the bid in response to a defensive measure by the target

enterprise.³³

In Germany, the takeover system is regulated by a single special law that concerns the advertisement of securities and takeovers ('Wertpapierwerbs-und Übernahmegesetz'). This law applies the mandatory bid rule for shareholders who have stocks in the target firm of more than 30% ex ante and wishes to purchase further stock. The rule obliges the bidder to offer to purchase the stock of all shareholders at an equitable price, and prohibits him from withdrawing or altering the bid. A regulator assesses if the offered price is equitable and if the bidder has enough funds to purchase all concerned stocks.

US federal law corresponds to the aforementioned first strategy, and the German system corresponds to the second. The latter belongs to the European model, which originated in the United Kingdom.

Japan's Financial Instruments and Exchange Act, which regulates the takeover system, is based on the US principle. Although the law introduced the mandatory bid rule in the 2006 amendment, the object of the Japanese regulation is remarkably different from the European model. The mandatory bid rule is applied only for the purchase of stocks of more than two-thirds of the target firm ex-post, and is not applied to transactions on stock exchanges and new issues.³⁴

(iii) Duties of the directors of the target enterprise

In the United States, state corporate law regulates the duties of the directors of target enterprises. Among them, the Delaware Code is the most popular. According to that law, responses to takeover bids are also covered by the business judgment principle, and thus directors have a relatively free hand. However, directors have a stronger duty regarding actions against takeover bids than for any other business decision. The Unocal standard for anti-takeover measures demands rational reasoning to prove that the offer is a threat to the target enterprise and written notification of the defense measure to the takeover offer. The Revlon duty obliges the directors of target enterprises to act to maximize shareholders' returns in the case of a power transfer.³⁵

In Germany, corporate law charges the directors of the target enterprise with the duty

³³ See Steinberg [2008] and Furuyama [1988, 1990].

³⁴ See Fujita [2011].

³⁵ See Milhaupt [2009].

of neutrality because the takeover bid can produce conflicts of interest. The general principle of German corporate law, 'Wertpapierwerbs-und Übernahmegesetz' includes a provision stating a director's duty of neutrality. This duty is intended to correspond to the aforementioned control by the regulator. However, there is a substantial exemption in the provision of the law that allows the directors to apply takeover defense measures in the 'the interest of the enterprise'. Although this loophole significantly differs from the original European model (which originated in the United Kingdom), it is rarely used.

In Japan, discussions have focused on anti-takeover measures, such as the aforementioned 2005 guideline. However, the duty of directors in response to a takeover bid has not yet been clearly defined, similar to the Revlon duty in the United States and the duty of neutrality in Germany. This issue has been discussed within the notion of the duty of diligence as a good manager. For example, the judgment of the 'Nippon Broadcast' affair found that the director was not liable to a third party who purchased the stock of a target enterprise at a price lower than the market prices.³⁶

(5) Effects on the behavior of enterprises

(i) Effects of legal systems on takeovers in Japan

With regard to the balance between the bidder and target enterprise, Japanese takeover regulations seem to provide relatively more advantage to the directors of the target enterprise. For example, the Japanese Financial Instruments and Exchange Law is based on the US model, but also introduced in part the mandatory offer rule. Thus, potential takeover bidders may view this regulation as more restrictive than that in the United States. In contrast, the Japanese judiciary has not charged the directors of target enterprises in the context of stock transactions with any specific duties on, similar to the Revlon duty. The duty of neutrality, as in Europe, has not been considered.

This combination may have strong effects on the incentive structures of the parties concerned. The directors may have the impression that their freedom to reject the offer has been confirmed by the authorities. The principle of shareholders' will and the common interest of the enterprise might enable management to defend as they like, particularly regarding enterprises dominated by 'stable shareholders'.³⁷ In contrast, the potential takeover bidder may be concerned about the uncertainty of the response by the target

³⁶ See Tanaka [2007].

³⁷ See Fujishima [2009], Milhaupt [2005, 2009], and Armour, Jacobs & Milhaupt [2011].

enterprise. They cannot expect the behavior of the target enterprise to be based on economic rationality in the capital market. As the main purpose of the takeover for the bidder is the purchase of time, the uncertainty surrounding potential drawn out conflict with management acts as a deterrent.

There are numerous anti-takeover clauses included in state corporate law in the United States. However, there is competition among the states, so that an enterprise will move to the state that has the most economically rational mechanisms. In Germany the duty of neutrality offers a loophole as well. However, this exemption is rarely used. It is possible that the notion of the 'interest of the enterprise' is carefully interpreted, so that directors fear accusations of responsibility as they pursue their own private benefits. A US study stated that the system also worked to enhance the capital market in combination with other measures such as tax advantages for such transactions in capital markets.³⁸

I believe that takeover activities in Japan are substantially restricted by the related legal systems in comparison with Germany and the United States. This is not only the result of the authorities' actions but also because stable shareholders are dominant in many Japanese enterprises. Stable shareholders will generally support the management body to reject the takeover offer, regardless of the monetary return proposed by the bidder. Under these circumstances, the potential bidder is obliged to forgo the economic possibility of the takeover.

The number and value of M&A involving Japanese enterprises peaked in 2006 as indicated in Chart 12. The rates of global M&A first fell in 2008, clearly influenced by the global financial crisis. I believe that the decline of M&A in Japan prior to the financial crisis may have been the result of the aforementioned regulation. Thus, attention should be directed at the discrepancies in the development of the inward M&A and all M&A in Japan. Inward M&A started to decline in 2008 in tandem with global M&A, and the M&A of domestic bidders started to decline in 2006.

(ii) Effects of M&A on the performance of individual enterprises

The takeover system influences the performance of enterprises in two ways. The first is the effects of M&A backed by the takeover system on the performance of integrated individual enterprises. The second is the effects of the takeover system on enterprises in general, those that have not integrated but have been disciplined by the threat of the

³⁸ See Gordon [2003].

takeover bid.

As for the first effect, there are pros (such as an increase in the economies of scale, the synergy effect, and a reduction of indirect costs) and cons (such as the difficulty of amalgamation and the cost of internal adjustment). The relative importance of these factors depends on the individual case.

There are several examples of econometrical research on this topic. Generally speaking, many of them conclude that M&A have a positive effect on productivity and profitability.³⁹ One study examined the various types of M&A and found that M&A of non-rescue, initiated by foreign capital and cross-segments, perform better type. However, another study pointed out that it depends on the length of the observed sample period because the effect of an M&A takes time to emerge.

Hostile takeovers are rare in most countries, but their possibility in general significantly enhances M&A because negotiations are often assisted under the shadow of the threat of failure or hostile takeover. The management body of a target enterprise will not accept an offer by a purchaser without imagining an ace at the table.

(iii) Effects on the behavior of Japanese enterprises in general

Regarding the effect of the takeover system on enterprises in general, economic theory tells us that the threat of takeover instills in management the market discipline to take proper risks to achieve higher profit by investing its internal cash reserves. However, it is difficult to detect the disciplinary effect of the possibility of a takeover because of the difficulties of sampling and controlling the influence of other factors. I now introduce various analyses related with takeover bids to determine the effects of the threat of takeover.

First, I ask what type of enterprises are target enterprises.⁴⁰ According to the analysis used here, a decline in profitability tends to trigger takeover attempts.

Second, I examine research on the characteristics of enterprises that have introduced takeover defense measures. According to this research, those enterprises generally have

³⁹ See Miyajima [2007] and Krose, Hun Park, Kwangwoo Park and Suzuki [2006].

⁴⁰ See Lel & Millar [2011].

higher liquidity assets ratios, a long history as a company, and cross-shareholdings.⁴¹ I will also introduce an econometric analysis on the impact of takeover defense measures on the stock price of enterprises. According to the estimation, the defense measure has a significantly negative effect on stock prices.⁴² These studies demonstrate that the perception of takeover defense measures in the stock market was that the aim of the measures is not the protection of shareholder profit.

Third, a further case study found that the activities of the target enterprise's directors were conducted to increase cross-shareholdings and gave priority to employee benefits rather than to shareholder profit.⁴³

Furthermore, an empirical study from the United States argued that management bodies (in the states where anti-takeover clauses are incorporated via legal systems) try very hard to appease employees and to avoid the necessary reorganization of their factories.⁴⁴

Based on these studies, I assume that the decline in takeover rates could mitigate the market pressure on the management bodies of Japanese listed firms.

(iv) Effects of the legal systems of takeovers on the behavior of Japanese enterprises

In sum, I present the hypothesis that a potential takeover bidder might view Japanese legal systems as contrary to the market principle compared with those in the United States and Germany. What is particularly crucial is the fact that the duties of the directors of the target enterprise are not specified in terms of economic rationality in the capital market, just like the Revlon duty. Furthermore, the regulation regarding the takeover bidder remains basically the same as in the US model.⁴⁵ There is a significant imbalance in the discretionary powers of the bidder and the target enterprise in Japanese legal systems.

I propose that this imbalance is caused by the division of the legal planning system, between capital markets law and corporate law. The related authorities only attempted to strike a balance within their own chargeable field, and brought about an imbalance throughout the entire system.

⁴¹ See Takizawa, Tsuru & Hishino [2010].

⁴² See Takemura, Shirasy & Kawakita [2010].

⁴³ See Sho & Tanaka [2009].

⁴⁴ See Bertrand & Mullainathan [2003].

⁴⁵ See Iwakura [2010].

I will now provide the second part of the hypothesis: the imbalance in legal systems may result in the lower profitability and larger internal cash reserves of Japanese enterprises via two channels, i.e., an insufficient reorganization of industry and weak market pressure on individual enterprises.

In the mid-2000s, a harsh discussion arose in the media regarding an attack of foreign capitalism or Mormonism. Legal systems were amended with this in mind. In addition, administrative mechanisms were also amended to strengthen the control of inward investment. According to OECD sources, Japan is one of the closest markets to discourage FDI.

However, looking back I have concerns that the legal systems concerning takeovers have had an unintended effect; they have restricted the reorganization and risk taking of the major players in the core industries of Japan. Japanese industries currently have more players in every segment compared with foreign competitors, and thus are disadvantaged in terms of economies of scale and scope.

5 Shareholder Activities⁴⁶

(1) Issues for discussion

Even if management wants to retain excessive cash reserves for the reasons stated above, the shareholders have voting rights to request a cash payout of their interest. If they acquire free cash released from the enterprise, they can then invest in the stocks of enterprises that have greater growth potential and profitability. This mechanism could work to enhance industrial growth.

However, as I explained in section 3(1)(i), much of the literature demonstrates that Japanese enterprises tend to retain substantial internal reserves against free cash flow. The literature also states that Japanese enterprises have more liquidity in their assets and lower dividend payout ratios than foreign enterprises. In addition, Japanese enterprises employ a 'stable dividends' policy, and return only a small part of their free cash via stock repurchases.

Shareholders have a voting right to appoint directors and decide their compensation. Therefore, they are likely to force directors to return cash as happens in other countries. However, there are necessary conditions that must be met before shareholders can use their rights effectively. The first is that they have the incentive to do so. The second is that they have sufficient information concerning the enterprise. The following discussion focuses on this issue: are these conditions satisfied in Japan?

(2) Incentive structure of parties related to shareholder activities

(i) Incentive structures of investors

Generally speaking, an investor purchases the stocks of an enterprise to gain benefits of two kinds. The first is a common benefit for all shareholders such as an increase in equity value and the payout of free cash via dividends or stock repurchases. The second is a private benefit for individual shareholders such as the security of having one's own credit or to develop a deeper business relationship with the issuer.

From this point of view, individual investors, except the founder's family, are give priority to common benefits. The next genuine investors are institutional investors such as foreign investment funds or domestic public pension funds.

⁴⁶ Additional references for this section include Uno & Kamiyama [2009] and Egawa [2008].

In contrast, industry firms give priority to private benefits. There are also financial institutions such as insurance companies or commercial banks. These institutions have both common interests (monetary returns) and specific interests (the enlargement of insurance policies or the security of credit to the issuer).

According to this categorization, cross-shareholdings are an extreme case of mutual stockholdings, which aims to produce private benefits on both sides, for example the self-defense of the management bodies of both enterprises.

In addition, mutual companies, the most common type of life insurance company in Japan, receive scant pressure from their policyholders to gain monetary returns from their stockholdings. They tend to use their stocks as a lever to increase the number of insurance policies held by the employees of the issuer. In the case of the company communities of Japanese enterprises, it is quite natural for life insurance companies to become the ruling party shareholders of the current management in return for insurance policies.

(ii) Liquidity versus control

There is an inevitable contradiction in the investment strategies of a fund manager, i.e., liquidity versus control. If he wants to have enough reserves to pay back individual investors, he cannot concentrate the fund in the particular financial instruments of an individual issuer, which is typically necessary to exercise the governance power. If he did so he would suffer from negative market impacts in the case of a selloff, or would risk being accused of being an insider trader.⁴⁷

Whether a fund manager follows liquidity or control depends on the characteristics of the fund resource. A fund manager with long-term fund resources such as pensions or equity can actively execute their control over the issuer enterprise.

(3) Stable shareholders in Japan

(i) Recent developments in shareholdings in Japan

In recent years the composition of shareholders in Japan by investor type has changed significantly, as indicated in Chart 14. The proportion of banks and individuals has

⁴⁷ See Coffee [1991].

significantly decreased, and that of foreign investors and institutional investors has increased.

The actions taken by shareholders on corporate governance has also changed in accordance with the change in investor type in Japan. The main bank system was the prevailing system in Japan but its effectiveness has significantly decreased since the 1990s.

(ii) Foreign investors

Foreign investors are the main players in the Japanese stock market. They make churning transactions to gain monetary profit in dollar terms. As the Yen rate has continuously appreciated while stock prices have stagnated in the long run, many foreign investors have shown greater interest in the national economy than in the performance of individual listed firms. In addition, these investors usually deal in stocks with ample market liquidity because they give more priority to liquidity than control.

Furthermore, the cost to foreign investors to collect the necessary information of listed firms is greater than for domestic investors. Therefore, they are more interested in the stocks of global business players. They also prefer the stocks of listed firms that have better disclosure and better investor relationship systems.

Since the 1990s, more foreign investors such as private equity funds have become block shareholders and as a result have a greater influence on corporate governance. In some instances these investors played the role of active shareholders of several listed firms, which resulted in conflict with directors. The target firms in such cases would have had offered regulatory merits or held a special position in the industry. The influence of foreign investors on corporate governance varies significantly by the type of listed firms.

(iii) Domestic institutional investors

Among institutional investors in Japan, life insurance companies and pension funds enjoy a large share, while equity investment trusts, which can act as block shareholders, possess a smaller share.

Life insurance companies in Japan are mostly mutual companies, which are exposed to less pressure from policyholders to pursue monetary profit from their shareholdings. These insurance companies seek to obtain further policyholders and are therefore more interested in the growth of the enterprise rather than its profitability.

Pension funds are potentially the main players in active corporate governance as block shareholders with a long time horizon. As they engage in 'passive' investment, they have enough motivation to execute corporate governance power to gain greater monetary returns. For example, in 2007 the Pension Fund Association of Japan instituted its corporate governance principle to enhance the introduction of independent outside directors onto management boards. In the following year the association instituted a guideline for voting to enhance the assessment of takeover defense measures by independent outside directors.⁴⁸

Japanese pension funds recently matured. Their funds have decreased as retirement rates have been increasing for a number of years. My thoughts on the matter are that they are forced to seek liquidity rather than control because they have to prepare for greater future payments.

Under these conditions, domestic institutional investors have played a less active role in corporate governance in Japan.

(iv) Stable shareholders

Management would feel more secure if they had significant stable shareholder numbers that would act as the ruling party in shareholder meetings. It is common for Japanese directors to make effort to maintain the number of stable shareholders.

However, the situation is different depending on the type of listed firm concerned. A previous study categorized Japanese listed firms as either enterprise with global standards of governance, newly emerging enterprises with effective shareholders' control, or as traditional listed firms.⁴⁹

Regarding this heterogeneity, Chart 15 shows how the management bodies of listed firms view the weight of their stable shareholders. Using data from a survey by a legal publisher, I show that stable shareholders are the majority in smaller firms; in contrast, they remain the minority in larger firms.

I regard cross-shareholding as an extreme outcome of the operation for the majority of stable shareholders in the context of this paper. Furthermore, Cross-holdings are frequently

⁴⁸ See Kawakita [2003] and Horie [2004].

⁴⁹ See Miyajima [2007].

accused as hollowing of the capital bases of enterprises. The directors of Japanese listed firms encourage cross-shareholdings as an extra measure to assure the majority of the ruling party when they face an emergent danger such as a takeover bid by an outsider of the company community. In this regard, a recent study noted an increase in cross-shareholdings between industry firms in the mid-2000s, when activist funds attracted the attention of the business world in Japan.⁵⁰ However, a further study claims that the number of cross-holdings is decreasing.⁵¹

(4) Comparison with the US and Germany

(i) Pattern of shareholdings

The present pattern of shareholdings in Japan differs from the United States, but is similar to that in Germany. Although there are no accurate statistics on the matter, the shareholdings of Japanese investment trusts is clearly smaller than those in the United States. In addition, Japanese pension funds invest a smaller part of their assets in equities compared with the United States. As for Germany, statistics sourced from a stock exchange federation indicate that the shareholdings are similar to those in Japan.

As for comparisons with the previous main banking system in Japan, the United States has never experienced that kind of block shareholding by banks. In contrast, Germany had an earlier system ('Deutschland AG') that was similar with the Japanese system. However, this system also failed in Germany. Stable shareholdings or cross-shareholdings are not currently common in Germany. In addition, shareholdings by industry firms are mostly used for vertical control in contrast to horizontal cross-holdings in Japan.

(ii) Legal systems for disclosure and accountability

Generally speaking, a shareholder requires two conditions to act as a controlling player. The first condition is the motivation to execute shareholder rights to force the issuer to produce bigger returns. In the case of the institutional investor, pressure on the fund manager from a beneficiary produces a stronger motivation. The second is information that can be used as a guide in communications with directors. Examples of such information include the purpose of large shareholdings and directors' compensation systems.

⁵⁰ See Nitta [2009].

⁵¹ See Itoh [2010].

The disclosure system is the foundation for these two elements.⁵² Thus, the responsibility of management for the disclosure and accountability of financial reports and corporate governance systems is the key in the related legal systems from the viewpoint of this paper.

In this regard, the most remarkable legal framework in the United States is the Sarbanes-Oxley Act. This act was established in 2002 as a response to the various corporate and accounting scandals of the time, such as Enron and WorldCom. This act and related rules contain many issues such as auditor independence, corporate governance, enhanced financial disclosure, and the establishment of the Public Company Accounting Oversight Board. In the context of this paper, it is particularly crucial for this act to find directors individually liable for the accuracy and validity of corporate financial reports. To comply with this rule, management is required to establish and maintain an adequate internal control system and produce a report on the system as a part of the annual report. In addition, external auditors are required to directly assess the internal control system and to include their opinion in the audit report.

Germany took a different approach. It introduced 'Deutscher Corporate Governance Kodex' in corporate law as a part of its corporate governance and capital market reforms in the 2000s. This institution follows the basic concept of 'comply or explain,' which is a common principle in EU countries. The 'kodex' includes broad issues concerning the internal organizations of enterprises, transparency, and the independence of auditors. The content of the codes are categorized as minimum standards, recommended codes, and best practices. Enterprises are not compelled to comply with the latter two categories, but they have to explain the reason for the deviation. The implementation of the 'kodex' has been periodically reviewed and has been frequently amended by a governmental commission.⁵³

Japan compromised and introduced aspects of both systems. That is, Japan introduced an internal control system regulation, similar to that in the United States, cited as the J-SOX law. However, the Japanese regulation did not include direct reporting by an external auditor. This is sometimes pointed out as an essential difference to the US system. Japan introduced also German-type corporate governance disclosure such as the requirement to disclose the purpose of large shareholdings or individual compensation of directors. However, this system was implemented in the market law system, for example in the Financial Instruments and Exchange Law and in the listing agreements of stock exchanges in contrast to

⁵² See Leuz and Wysocki [2008].

⁵³ See Regierungskommission [2012] and Tabuchi & Bebenroth [2006].

Germany.⁵⁴

(iii) Effectiveness of governance

As for 'legal systems in practice', both Japanese mechanisms are not as effective as their counterparts.

The effects of the J-SOX law are totally different to that of the US SOX act. Although the US system has often been criticized for making management too timid, the Japanese system has been claimed to have failed in its aim to strengthen the position of shareholders in terms of disclosure and of not creating defensive management. The reasons for these failures are the weak enforcement system; not only a lack of direct reporting by the external auditor but also weak public enforcement and an insufficient independent director system.

Besides, corporate governance disclosure in Japan has not yet achieved its original purpose as well. According to a survey on the disclosure of the purpose of large-scale shareholdings without a genuine monetary investment purpose, most descriptions are curt and nonspecific such as 'necessary for the businesses.'⁵⁵ Although this kind of conduct ignores the aim of the disclosure regulation, it is not illegal and therefore escapes penalty. In my view, corporate governance disclosure in Japan has not been established as an autonomous discipline of management, but has merely produced unwilling compliance to rules charged by government.

In contrast, the German 'kodex' seems to work autonomously.⁵⁶ I reason that the effectiveness of this mechanism relies on the information flow between management and shareholders. German Corporate Law, includes a clause on the right of shareholders to access information regarding the 'kodex', According to my reasoning, German enterprises do not depend on the issuance of stock, as do US companies; therefore, the internal pressure of the enterprise's shareholders is more important than the reputational pressure of investors in the capital market. The Japanese corporate governance system does not work well because of the discrepancy between the US-type regulation and the Germany-type background of financial conditions.

Moreover, the relationship between the market law and corporate law are entirely

⁵⁴ See Nagashima, Ohno & Tunematsu Law firm [2010].

⁵⁵ See Yokoyama [2011].

⁵⁶ See Seki [2010].

different among the three countries. In the United States, the corporate laws are state laws, which are essentially heterogeneous and are mostly pro-management. Market laws are drafted by the federal government to shift the balance toward the protection of investors. In addition, the US financial system comes from a capital market tradition. Therefore, the disclosure of financial reports is at the core of the US legal framework.

Germany took a synchronized approach with its market and corporate law.⁵⁷ First, Germany introduced a unified special law for the specific field, for example the enactment of 'Wertpapierwerbs- und Übernahmegesetz' for takeover regulations. Second, the civil penalties, such as the suspension of the voting right, were applied for the violation of market laws (for example, ignoring the reporting obligation of large shareholdings). Third, wide-ranging legislation was enacted to enhance the capital market, from market law to corporate law.

In Japan, market law and corporate law are kept separate, with the exception of a few articles within the Financial Instruments and Exchange Law that governs investors' lawsuits. Corporate governance disclosure is not supported by the Corporate Law in Japan. In Germany not only statutory law but also judicial precedents support the corporate governance disclosure system. For example, a court found a director was liable to a shareholder for falsifying a recommended item of the 'kodex'.⁵⁸ Thus, the corporate governance disclosure in Germany works better than that of Japan through overcoming the dogma of separation between public law and private law.

(5) Effects on the behavior of enterprises

Although Japanese corporate law provides strong rights for shareholders in 'the laws on the book', they do not utilize these rights in terms of 'legal systems in practice' because of their characteristics as investors and the lack of accurate information regarding the corporate governance system.

According to literature concerning corporate governance, the activities of shareholders do influence the performance of enterprises. There are many studies on the influence of foreign shareholders, whose interests concentrate on monetary returns. Many of these studies conclude that foreign shareholdings induce a better performance via management

⁵⁷ See Kansaku [2013].

⁵⁸ See Tröger [2011].

discipline and the reform of the corporate governance structure.⁵⁹ For example, an empirical analysis regarding the performance of listed firms from 1985 to 2000 indicated that firms with higher foreign shareholdings and lower stable shareholders have better productivity.

Based on these analyses and the above explanation of the incentive structure of investors and management, I present the following hypotheses.

- As many of the shareholders of Japanese listed firms have a greater interest in obtaining individual benefits in their business relationships, they do not apply enough pressure on management for higher monetary returns via increases in shareholders' value or by paying out internal cash reserves.
- The background to this preference lies in the fact that disclosure and accountability within the corporate governance system are not established as an autonomous discipline in the market but as a mere compliance to the regulation charged by the authority.
- This preference may also weaken the governance of management resulting in low profitability and rich cash reserves.

⁵⁹ See Miyajima & Nitta [2011] and Nishizaki & Kurasawa [2003].

6 Enforcement of enterprise law⁶⁰

(1) Issues for discussion

The right of exit is the first choice for a minority shareholder when he cannot expect a satisfactory return from the stock of an enterprise. At the same time, this right is a channel for market discipline on management because the disposal of stock in the market has a negative impact on stock price. If the stock price significantly falls, the directors are denounced via the frustration of the wider shareholders.

However, this right to exit cannot be always utilized in a timely manner. If a shareholder was harmed by a specific wrongdoing by management, he can initiate a lawsuit. If the wrongdoing is a breach of directors' duties, a shareholder can file a shareholder's derivative suit based on corporate law. Furthermore, if the wrongdoing was the false disclosure of financial conditions or corporate governance system, the shareholder can file a security lawsuits based on market law. The latter lawsuit represents the enforcement mechanism of market law to ensure the integrity of the capital market.

. The important element to be considered regarding shareholder lawsuits is the huge imbalance of information and resources between the enterprise defendant and the individual plaintiff. Without additional assistance to the plaintiff the lawsuit system would not work at all. Regarding such assistance, there are two legal strategies: a legal mechanism to strengthen private enforcement and a governmental organization to act as an agent for public enforcement.

The effectiveness of these enforcements is essential for the function of the capital market concerning the behavior of enterprises. In addition, the aforementioned strategies have, in turn, a significant influence on the incentive structure of management themselves. Of particular importance is the character of the legal risk facing management caused by the concrete measures taken in each enforcement system. Their incentive structure, and hence the behavior of the enterprise, is likely to be significantly influenced by the institutional structure.

(2) Measures to enforce enterprise law

⁶⁰ Additional references for this section include Ohjida [2011], Kondoh [2008], Naitoh[2011], Kyoto Comparative Law Center [2010], Matsui [2011], NERA economic consulting [2009, 2011a, 20 11b], The 21st Century Public Policy Institute [2011], Cheffins & Novak [2006], and Novak [2004].

(i) Capital markets law

The capital market dispenses certain discipline on the behavior of enterprises through the fluctuation of their stock prices. The preposition for this price finding function of the market is information integrity. The first purpose of capital markets law is to establish the integrity through fair creation, distribution, and utilization of the information of listed firms in the capital market.

There are two kinds of mechanisms for the enforcement of capital markets law. The first is private enforcement, which is based on lawsuits by individual investors. The second is public enforcement, which consists of various activities by the regulator, which begins with the accusation of the wrongdoer in the capital market.

This issue has been discussed in US legal literature with the title ‘What works in securities law?’ Roughly speaking from a glance at the literature, numerous studies have discussed the pros and cons of various measures to enforce capital markets law, based on a common recognition that effective enforcement is essential for the function of the capital market. For example, several studies have empirically analyzed the correlation between capital market size and the strength of the enforcement of securities law, identifying anti-director clauses, the efficiency of the court system, and the establishment of the disclosure system.⁶¹ The research found a significant correlation between the strong enforcement of securities law and the healthy functioning of the capital market. In addition, they discuss the comparative advantage of public enforcement compared with private enforcement. I see US common sense as giving priority to private enforcement. However, an empirical analysis that considered the available resources of regulators concluded that public enforcement significantly enhances capital market functions.⁶²

(ii) Corporate law

In this section I discuss the mechanisms to enforce corporate law regarding shareholder lawsuits against directors. The topic of creditor lawsuits against directors was discussed in section 3(3)(iii).

⁶¹ See La Porta, Lopez-de-Silanes & Shleifer [2003].

⁶² See Jackson & Roe [2009].

A shareholder cannot always sell stock, even if he notices the enterprise might not give him a satisfactory return. The negotiability of stock depends on a number of issues, including whether or not the stock is listed, liquidity in the market, the extent of dressing, and the timing of the wrongdoing. Therefore, shareholders are authorized to institute lawsuits against directors. The contest lawsuit is an ex ante measure and the liability lawsuit is an ex post measure. The latter is generally made in the form of a shareholder derivative suit, as the enterprise itself is not normally expected to pursue the liability of the concerned director.

(3) Incentive structure of parties related to enforcement

(i) Imbalance between litigants

Investors who consider a lawsuit under enterprise law weigh the probability of winning and expected profit with the probability of losing and the cost of the lawsuit.

In this regard, attention must be given to the reality that the individual investor has a large disadvantage in terms of information and resources compared with the enterprise and directors. If there is no adjustment in the legal mechanism, an investor may never become a plaintiff.

First, disclosure information pertinent to the lawsuit is essential. Therefore, legal systems contains clauses to ensure a shareholder's information right or pre-trial evidence proof for the potential plaintiff. The next hurdle for a potential plaintiff is the expected cost of the lawsuit. In this regard, collective litigation works to reduce the unit cost per individual plaintiff. Another choice is the reduction of the initial application fee to institute a lawsuit.

In contrast, the expected profit depends on the burden of proof, the amount of compensation, and related uncertainty. In particular situations, the legal systems prescribes the transfer regarding the responsibility of proof. In addition, case law can sometimes provide the standard for the calculation of compensation.

The efficiency of lawsuits is the important point for both litigants and the court system. For example, securities cases frequently bring mass lawsuits that cannot be efficiently processed via traditional civil procedure. Collective litigation works well in this regard. Of importance is to what extent and how the court should intervene in negotiations between litigants from the viewpoint of efficiency and the rationality of the lawsuit as an economic transaction.

(ii) Shareholders

Shareholders who believe they have suffered harm from an issuer of stock must consider the pros and cons of using the aforementioned legal systems.

From the viewpoint of the shareholder, corporate law and capital markets law are the alternative authorities for his appeal. Comparing the two, demands concerning corporate governance issues have relatively smaller weight in market lawsuits than corporate lawsuits. As for demands for monetary compensation, corporate lawsuits do not bring the shareholder a direct monetary award. The defendant should pay damages to the enterprise in the case of losing a derivative lawsuit.

In contrast, in the case of market lawsuits regarding false disclosure, the plaintiff expects a direct payment from the enterprise and the calculation of compensation is established based on the market efficiency hypothesis. However, the real effect of a security lawsuit is often considered as a just redistribution of an enterprise's assets among different classes of shareholders.

(iii) Regulators

Regulators have a fairly different incentive structure when considering the enforcement action of capital markets law. First, regulators do not focus their interest on a monetary award, unlike private plaintiffs. Second, available information is limited and biased toward the regulator. Shareholders have information rights under corporate law and the monetary motivation to examine the information. However, the regulator only collects a limited amount of information related to its authorized mandate. Third, the hurdle for regulators to take an action is not the difficulty of it being an individual case, but the constraints of the available resources. Fourth, regulators have their own authority to investigate, but the required standard of proof for criminal actions is far higher than that for private litigation.

(iv) Directors

The enforcement of enterprise law influences the incentive of directors via stock price formation. If capital markets law is implemented effectively, the capital market accurately exercises its pricing function. It produces a change in stock price that is expected to discipline management bodies in a risk-neutral manner.

Regarding lawsuits as a measure of law enforcement, the issue of 'who is the defendant' is a critical point. In the case of market lawsuits, the defendant is the issuer enterprise. In the case of shareholder derivative suits based on corporate law, the defendant is the director as an individual.

Defending a market law claim, management behaves as a representative of the company community as usual. The enterprise will claim that management are liable if unsuccessful, but this will be a matter of business judgment. The situation is similar for a contest lawsuit based on corporate law.

In contrast, the director is directly implicated by a shareholder derivative suit. He might be privately liable for excessive damage caused by the enterprise. In addition, the enterprise may not provide full assistance or insurance cover to him. Thus, the director would face significant uncertainty. Therefore, directors typically act to avoid the risk of shareholder lawsuits in their everyday business decisions. Directors do not typically wish to engage in high-risk business practices. This is particularly important for outside directors, so that their liability is generally more limited than that of insider directors.

(4) Comparison of legal systems concerning private enforcement

(i) Collective litigation under capital markets law

There is a sharp contrast between Japan and the United States in their legal systems concerning security lawsuits (see Chart 16).

In Japan, the Financial Instruments and Exchange Law introduced provisions that transfer the burden of proof to the issuer and clarify the calculation of compensation for the damage suffered. However, the use of securities law in Japan is rare. In addition, there is no collective litigation system for security lawsuits.⁶³ I reason that it is difficult for an individual investor to initiate legal action against an enterprise and therefore legal assistance cannot be substantially utilized in the process of a lawsuit.

In contrast, security lawsuits against issuers accused of engaging in false disclosure is quite common in the United States. American securities laws contain the provisions with criminal penalties for false disclosure, which are naturally interpreted as provisions for civil

⁶³ See Yokoyama [2012].

liability.⁶⁴ Law firms typically compose a class for litigation and negotiate with the issuer as the agent of the class. A recent study found that security lawsuits triggered by bankruptcy tend to favor plaintiffs.⁶⁵ In the process of negotiation, the law firm uses the discovery system to conduct fishing expeditions and to negotiate with the enterprise to achieve a favorable settlement.⁶⁶

The legal background to the number of security lawsuits in the United States indicates that the class action system reduces the unit cost for an individual plaintiff. The class action system in the United States employs an opt-out system in which the effect of the collective lawsuit judgment reaches all potential plaintiffs unless they present an opposite intention. The Private Security Litigation Reform Act was enacted in the United States in 1995 to prevent the abuse of security lawsuits by restricting potential plaintiffs.

Collective litigation in Germany is traditionally known as ‘Verbandsklage’ (association action), which permits qualified organizations such as consumer associations to represent members in suspension suits against an enterprise. Regarding capital markets law, the Act on Model Proceeding in Capital Market Dispute (‘Das Gesetz über Musterverfahren in Kapitalmarktrechtlichen Streitigkeiten’) was introduced as temporary experimental law from 2005 to 2012. This law was in response to the mass disputes caused by the false disclosure in the Deutsche Telecom affair. Constitutional litigation was instigated to appeal the decision that the right of shareholders to sue was substantially violated because the court process was too clogged to achieve a timely resolution. Although the constitutional court dismissed the appeal, the German congress legislated the aforementioned law. This law aims to speed up the process of security lawsuits by using a model case assembled from a number of lawsuits with a similar cause and by then assessing the case in the upper class court from its beginning.

This act has not worked well so far. The reason for this is that the act does not employ the opt-out system as do class actions in the United States and the cost for the model case should be at the expense of the individual plaintiff of the case. However, the term of the experimental law was further extended with the hope of improving the legislation.⁶⁷

Thus, there is an obvious contrast between Japan and the United States in terms of

⁶⁴ See Staeinberg [2008].

⁶⁵ See Park [2012].

⁶⁶ See Asaka [2008].

⁶⁷ See Baetge [2010], Bälz & Blobe [2007] and Takada [2011a, 2011b].

shareholders' litigation systems. Germany's previous system was closer to that in Japan but has now moved to somewhere between the two.

(ii) Legal industry

The various characteristics of the legal industry are sometimes considered a further reason for the differences between the collective litigation processes of Japan and the United States.⁶⁸ For example, the class action system is viewed as a tool for the promotion of US law firms. Investors similarly consider the proposals of law firms as a business opportunity. In contrast, the Japanese legal industry does not engage in such practices and investors view lawsuits as a very serious matter.

However, I believe that the economic mechanism would also work in the Japanese litigation system for the following reasons.

First, the number of shareholder derivative suits suddenly increased in Japan once the application fee for a derivative suit was set at a lower level. The balance of the expected return and costs also had a strong impact on the frequency of lawsuits in Japan.

Second, Japan has many examples of an increase of lawsuits after the occurrence of a pivotal event. In addition, many consider that those lawsuits took too long to reach their conclusions. The intention of the German lawmakers was to address such criticisms while avoiding the sub-effect of abuse under the collective litigation system as in the United States.

Third, Japanese courts have recorded remarkable achievements in disputes concerning traffic accidents. In the early period of motorization, a Tokyo district court judge established standards for legal processes and the calculation of compensations. These standards were then implemented by insurance companies that provided liability insurance policies and special contracts for legal services.⁶⁹ Thus, even though litigation itself is not common, a legal function to find the optimum solution for disputes has been effectively implemented.

For these reasons, I believe that the Japanese method of the private enforcement of capital market law can be established by the relevant legal systems with appropriate

⁶⁸ See Asaka [2008].

⁶⁹ See Watanabe [2011].

assistance.

(iii) Availability of information

I believe the reason why security lawsuits in Japan are not as common as in the United States is that the lack of information makes the prospect of lawsuits unfavorable for those shareholders who are potential plaintiffs.

First, I will compare the clues for those security lawsuits. In the United States, the clues for legal action by shareholders are movements in stock prices, fluctuations of disclosure, bankruptcy, takeovers, and news of these events. In contrast, Japanese shareholders depend on the actions of regulators or criminal scandals for their indicator information regarding appropriate mechanisms. As for Germany, the protection of shareholders is based on information rights, from which clues for litigation may be obtained.⁷⁰

Second, legal systems that adjust the information asymmetry between an individual and an enterprise in a lawsuit can be compared. Japan amended its Civil Process Code as a part of the overall reform of the judicial system. In 1998, the system that governed discovery orders was revised and a pre-trial information collection system was introduced in 2004. The purpose of these reforms was to speed up and strengthen the lawsuit process.⁷¹

In contrast, in the United States, the discovery system has been widely used for some time. The pre-trial discovery system also works well in security lawsuits. Regarding Germany, its independent evidence system was introduced to promote dispute resolution via settlement. However, the discovery system is seldom used because of the difficulty to identify the document to be discovered.⁷²

Third, the termination of a shareholder lawsuit in Japan is basically a judgment that follows a long period of procedures. In contrast, security lawsuits in the United States are terminated via compromise. Thus, US litigants play legal games under the process control of the court, while Japanese litigants appeal to judges to decide. The background to the US process is mutual illumination via the discovery system and an established standard to calculate compensation amounts. The situation in Germany is similar to Japan in this regard.

⁷⁰ See Behrendt [2012].

⁷¹ See Araki [1998] & Nakane [2003].

⁷² See Yoshida [2002].

Based on these comparisons, I reason that when Japanese shareholders balance the pros and cons of a security lawsuit, the result may not be favorable and is accompanied by significant uncertainty. The discovery system in particular does not assist the plaintiff.⁷³ Thus, shareholders may view lawsuits as a last resort.

(iv) Private lawsuits under corporate law

The major weapon for Japanese shareholders is the shareholder derivative suit. This system was introduced just after World War II, but was not activated until the 1993 amendment of the Commercial Code. This amendment states that shareholder derivative suits are not lawsuits under property rights and hence the application fee should be at a minimum. Thus, the balance of shareholder lawsuits became significantly favorable to shareholders.⁷⁴ Eligibility to be a plaintiff in a derivative suit is broadly defined because he is regarded as 'an agent for litigation at law' in the Civil Process Code.⁷⁵

In the United States, shareholder derivative suits seem to be relatively common, and based on state company law. However, eligibility to be a plaintiff is strictly assessed and independent directors can request the court to disallow the application, unlike in Japan.

As for Germany, shareholder derivative suits are not generally used because plaintiff eligibility is restricted and the probability of a director's wrongdoing must be presented to accept the filing of the lawsuit. In contrast with Japan, the contest lawsuit (*Anfechtungsklage*) system is frequently employed by shareholders in Germany.

I find little economic rationality for a minority shareholder to be a plaintiff in a derivative lawsuit. Rather than enabling legal negotiations between equal litigants the lawsuit appears to be a tool to demand justice for a protester. As stated above, the 1993 amendment of the Commercial Code was in response to the indignation about the corporate scandals of the day.

In addition, I believe that the German system would encourage shareholders to be more proactive against management bodies than the Japanese system. Japanese shareholders lawsuits are generally triggered by public events such as factory accidents or police investigations. In Japan shareholder action is reactive and their appeals often look in

⁷³ See Deguchi [2009] and Totsuka [1999].

⁷⁴ See Kanda & Milhaupt [2003].

⁷⁵ See Itoh [2007].

hindsight to be based on criticism of some matter. However, the strong information rights of shareholders in practice are essential for the German system to work effectively.⁷⁶

(5) Comparison of the public enforcement of capital market law

(i) Regulators

The Securities Exchange and Surveillance Commission (SESC) regulates the capital market in Japan.

The SESC was established in 1992 in response to the securities and finance scandals of the day. However, until the early 2000s its organizational resources were limited and its activities were concentrated to the filing of criminal charges with the public prosecutor under market law. In the early days the commission carefully conducted reconnaissance investigations to build up enough evidence to request a court permit for a compulsory investigation. This behavior was regarded as rational under the restraint of those days, and the long lead time was necessary for the regulator to take official action. During this preparatory period, the misconduct can sometimes become prevalent. As a result, the capital market could experience disruptions such as during the investigation of the Livedoor affair.

Since this event, the function of the SESC has been reinforced. In 2005 an administrative monetary penalty system was introduced and an investigation authority to impose penalties was delegated to the SESC. In the same year the authority to inspect disclosure statement was delegated to the commission and its authority to inspect capital market intermediaries was enlarged. In addition, staff numbers at the SESC have increased from 200 in the early 2000s to 700 at the end of fiscal year 2011.

In the United States, the regulator is the Securities Exchange Commission (SEC), which traditionally has had greater resources and a broader authority including rule making and the supervision of financial intermediaries. Staff numbers in 2010 reached 3,750. In addition, the SEC has various measures to enforce US market laws, such as administrative proceedings, civil lawsuits, and trading suspensions. Its budget stems from fees paid by capital market participants and is financially independent from the US government. Thus, the

⁷⁶ See Behrendt [2012].

characteristics of the SEC are very different to that of the SESC.⁷⁷

The role of the capital market regulator in Germany falls on the Federal Agency for Financial Services Supervision ('Bundesanstalt für Finanzdienstleistungsaufsicht', hereafter 'Bafin'). This agency governs Germany's banks and insurance companies in addition to the market regulation. The Bafin executes its market regulation similar to Japan, such as the filing criminal charges with the prosecutor and the administrative order regarding misconduct in the capital market. The assessment of takeover bids is also lies with the Bafin. The agency employs a small staff (as does the Japanese SESC) of approximately 350. However, the Bafin's budget, as in the United States, is based on participants' fees and is independent from the German government.⁷⁸

(ii) Public enforcement measures

The enforcement measures of the SEC are entirely different to those of its Japanese and German counterparts. That is, the SEC processes civil lawsuits for false disclosure or misconduct in the capital market. The Japanese SESC introduced investigations for administrative monetary penalties; these can be implemented in a timelier manner than for criminal charges. However, this system is essentially the execution of governmental power; therefore, the burden of proof tends to be higher than when filing a civil lawsuit.

The most remarkable difference with the Japanese SEC is that it engages in disgorgement activities that distribute the wrongdoers' profits to the harmed investors. Here the SEC works as a representative of the harmed investors.

As stated previously, most public enforcements in the United States are terminated via compromised-reached resolutions and those in Japan ended with an administrative order or judgment after a numerous drawn out procedures.

Thus, there are significant differences between Japan and the United States regarding the public enforcement of market law; Germany is placed somewhere between the two. The placement of these countries is also typical for other issues concerning the function of the capital market.

(6) Combination of the private and public enforcement of market law

⁷⁷ See the Securities and Exchange Commission [2012].

⁷⁸ See Bundesanstalt für Finanzdienstleistungsaufsicht [2011]

(i) Relative importance of private and public enforcements

There is significant literature concerning the relationship between the private and public enforcement of market law. Some studies discuss the role of the public enforcer in the context of 'the imperfect law'. According to this theory, innovation in the capital market is so rapid that statutory laws become obsolete. The regulator can respond to financial innovations quickly and can therefore play a larger role in the capital market than in other fields.⁷⁹

However, it should be noted that the incentive structures of investors and regulators are different. In Japan investors are likely to depend on enforcement by the regulator, which has relatively limited resources and information in its search for clues. In addition, regulatory rules must be clear and expected because they apply criminal or administrative penalties against the violator. Furthermore, the regulator has a limited scope to execute their mandates. Ex post compromises or ex ante contracts concerning administrative measures do not exist in the Japanese practice of market law regulation.

The incentive structure of market participants is influenced by the relative weight of the private and public enforcement of market law. Under the Japanese system, enforcement is weak and limited. In addition, market participants are influenced toward reactive compliance to avoid the penalties handed out by the regulator.

The role sharing between investors and regulators in the enforcement of market law should also be examined. In the United States, the investors play a major role in enforcement, motivated by the expected monetary return of security lawsuits. An SEC member stated that the SEC plays a supplementary role, making much of the deterrence effect in their selection of target cases.⁸⁰

In this regard, attention should be given to a recent event in Japan where the court ordered the regulator to produce a document concerning an administrative measure as evidence in a private shareholder's lawsuit. In my opinion, this combination of public and private enforcement amplifies the bias in the incentive structure of market participants, albeit the order itself is entirely appropriate from the viewpoint of the individual case.

⁷⁹ See Xu & Pistor [2003].

⁸⁰ See Cox & Thomas [2003].

(ii) Role of accountants

Accountants play the role of the gatekeeper of capital markets among the various investors, regulators, and issuing management bodies.

As for the incentive structure of accountants in this paper, it is essential that they are targeted as having 'deep pockets' by creditors when the client enterprise fails. Audit fees are not generally linked with the creditworthiness of the client enterprise.

According to a report by the Japanese Institute of Certified Public Accountants, the Japanese legal institute is more rigorous for accountants than that in the United States and Germany, as a broader range of third parties can pursue the liability of accountants and the burden of proof falls on accountants. Furthermore, this threat has a strong influence on the incentive structure of accountants because there is no provision that limits their liability in corporate law.⁸¹

In contrast, accountants have a significant role in the enforcement of market law. In particular, accountants are authorized to audit the establishment and implementation of the internal control systems of client enterprises and present their opinions in an audit report. This system was introduced in the United States in the Sarbanes-Oxley Act in 2002. It has had a significant impact on the behavior of management in the United States by strengthening the surveillance power of the SEC and by increasing the compliance costs of listed firms.⁸²

Japan introduced a similar system but did not employ direct reporting. Japanese accountants are authorized to audit the management body's valuation of the internal control system within the general principle of dual responsibility in the auditing practice. Therefore, the Japanese system of internal control audit does not have as strong an impact as in the United States.

Regarding Germany, the 'Deutsche Corporate Governance Kodex' system is supposed to function as an alternative in the broad sense of the role of accountants on management.

However, there are several legal systems in Japan that link administrative measures with the financial reports of enterprises in individual laws such as bank supervision or

⁸¹ See the Japanese Institute of Certified Public Accountants [2010].

⁸² See Ookawa [2007].

government purchasing. Under these systems, accountants have direct influence on administrative decisions. The Prompt Corrective Action system for financial institutions pressed accountants, given the aforementioned concern about liability. Their cautious assessments of asset valuations may have a direct influence on the lending attitude of banks, which in turn could dampen enterprises' financial behaviors.

(7) Effects on the behavior of enterprises

(i) Magnitude and combination of the enforcement of market law

As explained above, the enforcement of market law in the United States is characterized by vigorous private shareholder actions and the supplementary activities of the large-scale regulator, the SEC. In contrast, private enforcements in Japan and Germany play only small roles and the resources of the regulators are limited. Still, the role of the SESC is disproportionately large in Japan compared with the investors.

From this comparison I propose the following.

First, the difference in magnitude of market law enforcement should influence the price finding function of the capital market, as stated in the literature. The weaker enforcement of market law in Japan tends to bring about weaker market discipline in listed firms.

Second, regulators have no incentive for monetary returns but a strong interest in the deterrence of misconduct in the capital market. In contrast, shareholders are supposed to take action more frequently if they are not satisfied with performance. Therefore, the relatively larger role of the regulator in enforcement in Japan might induce regulated firms to avoid the actions of the regulator rather than to take risks to obtain greater returns for shareholders.

Third, the activities of the Japanese regulator are directed mainly at the violations of regulations and it does not engage in civil lawsuits. This particular characteristic could further amplify its influence compared with the situation in the United States.

(ii) Lawsuits of shareholders

Security lawsuits in the United States are filed if the stock price falls, or if the financial disclosure indicates an inefficiency of management including an excessive cash reserve. This situation should give management the motivation to utilize the internal cash for risky but

profitable projects with sufficient disclosure to avoid lawsuits. It is difficult to imagine Japanese security lawsuits having such a function at this moment.

In addition, litigants in most US security lawsuits engage in a compromise by referring to precedent cases and standardized compensation.⁸³ Japanese lawsuits generally take a long time for a judgment to be handed down. It could be viewed that that directors in the United States take security lawsuits as an issue of risk management, and Japanese management take security lawsuit as an issue of tail risk.

In comparison with their US and German counterparts Japanese shareholders file more derivative suits based on company law.

Shareholder derivative suits are targeted at individual directors and have a strong influence on the incentive structures of management. They are therefore likely take the risk of derivative suits into consideration in their business judgments. The plaintiff of a shareholder derivative suit may have little monetary motivation because compensation will have to be paid to the enterprise if they win. Therefore, shareholder derivative lawsuits tend to be utilized for non-economic purposes.

Especially in Japan, the major clues of derivative lawsuits are reports by mass media, which tend to criticize the profit seeking of enterprises. One report stated that the low application fee was in response to the social anger that arose against the enterprise scandals of the day.⁸⁴ Thus, management might restrain from profit taking to avoid the criticism of the mass media and hence derivative lawsuits. There are very few examples of contracts to limit directors' liability (there were introduced via the 2001 amendment of Japan's company law).

(iii) Effects of enforcement of enterprise law on the behavior of Japanese enterprises

Summing up this section, I present the following hypotheses.

- The weaker enforcement of market law in Japan means weaker market discipline on listed firms.

⁸³ See Ikeya, Kishitani & Nakano [2009].

⁸⁴ See Yamada [2007].

- The balancing of pros and cons by Japanese shareholders when considering security lawsuits may not be favorable and is accompanied with large uncertainty because of information asymmetry and the time required for such lawsuits. This situation could reduce the motivation of management to utilize internal cash in risky but profitable projects.
- The relative importance of public enforcement in Japanese market law could influence the behavior of regulated firms and thus they act to avoid the action of the regulator rather than take risks for a greater return for shareholders.
- Compared with their US and German counterparts, Japanese shareholders frequently file derivative suits based on company law; this practice could have a strong influence on the incentive structure of management bodies. Therefore, management could take into consideration non-economic factors suits when making business decisions and have less motivation to pursue profitability as a result.

Conclusion

Below I present my hypotheses regarding Japanese legal systems and their effect on the behavior of enterprises.

- (i) The weak inducement to file early for bankruptcy and the accompanying increase in threats to employees could result in enterprises building large internal cash reserves.
- (ii) Potential takeover bidders view Japanese legal systems as contrary to the market principle compared with those in the United States and Germany because of the significant imbalance in the discretionary powers of the bidder and the target enterprise. It is possible that this imbalance causes lower profitability and larger internal cash reserves in Japanese enterprises via two channels, i.e., an insufficient reorganization of industry and weak market pressure on individual enterprises.
- (iii) As many shareholders of Japanese listed firms have a greater interest in individual benefits in their business relationships, they may not place adequate pressure on management for higher monetary returns. The background to this is that disclosure and accountability under the corporate governance system has not been established as an autonomous discipline in the market but merely as compliance to the regulations charged by the authority.
- (iv) The weaker enforcement of market law in Japan could explain the weaker market discipline on listed firms to pursue better performance for investors.
- (v) The pros and cons considered by Japanese shareholders regarding security lawsuits may not be favorable and are accompanied with uncertainty because of information asymmetries and long drawn out lawsuits. This situation could act to reduce the motivation of management to apply internal cash reserves to the risky but profitable projects.
- (vi) The relative importance of public enforcement in Japanese market laws might influence the behavior of regulated firms to avoid the actions of the regulator rather than to take risks to obtain greater returns for shareholders.
- (vii) Compared with their US and German counterparts, Japanese shareholders file more

derivative suits based on company law. This could have a strong influence on the incentive structures of management. Thus, they appear to take lawsuits based on non-economic factors into consideration in their business judgments and have relatively less motivation to pursue profitability as a result.

Finally, I would like to offer several comments on Japanese enterprises and the capital market based on my research to reach these hypotheses.

First, 'path dependency' is relatively evident in Japanese legal systems. Various reforms have been introduced, particularly in the capital market, under the slogan of 'from saving to investment'. However, the undercurrent of the legal systems has essentially remained unchanged. My research has shown that many mechanisms have retained the essence of traditional financial systems, composed of banks and their supervisors.

Second, compared with the United States, the Japanese economic society has little liquidity in the markets of directors, employees, and financial instruments. Company communities have remained stoutly unchanged. This situation may damage the activating function of financial markets and the opportunities for business innovation by new entries.

Third, compared with Germany, Japan lags remarkably in the reform of its enterprise law. The overt symptoms of financial crisis in 1997 triggered a sweeping reform of the banking and business reorganization system. Although the present rupture of the Japanese enterprise system is a chronic malady, it does not necessarily present a total disaster. Therefore, Japan has not comprehensively responded to the combination of rich cash reserves and low profitability, despite the situation being as serious as the previous non-performing loan problem. In contrast, Germany has confronted and overcome its challenges. This success was stimulated by the reunification of the country and the European single market.

Fourth, even if the discipline of the financial market is interrupted for the moment, surely the market mechanism will penetrate the Japanese economy in a wider sense. That is, the capital market is hollowing out because of the decrease in new listings and the increase in 'goings private'. In addition, the entire financial system is increasingly dependent on the government; for example, banks cannot lend any further to enterprises and are instead purchasing government bonds. Moreover, the sluggish reorganization or consolidation of enterprises is weakening the international competitiveness of Japanese industry. I believe a 'fallacy of composition' does indeed exist between the individual company community and Japan's national industry.

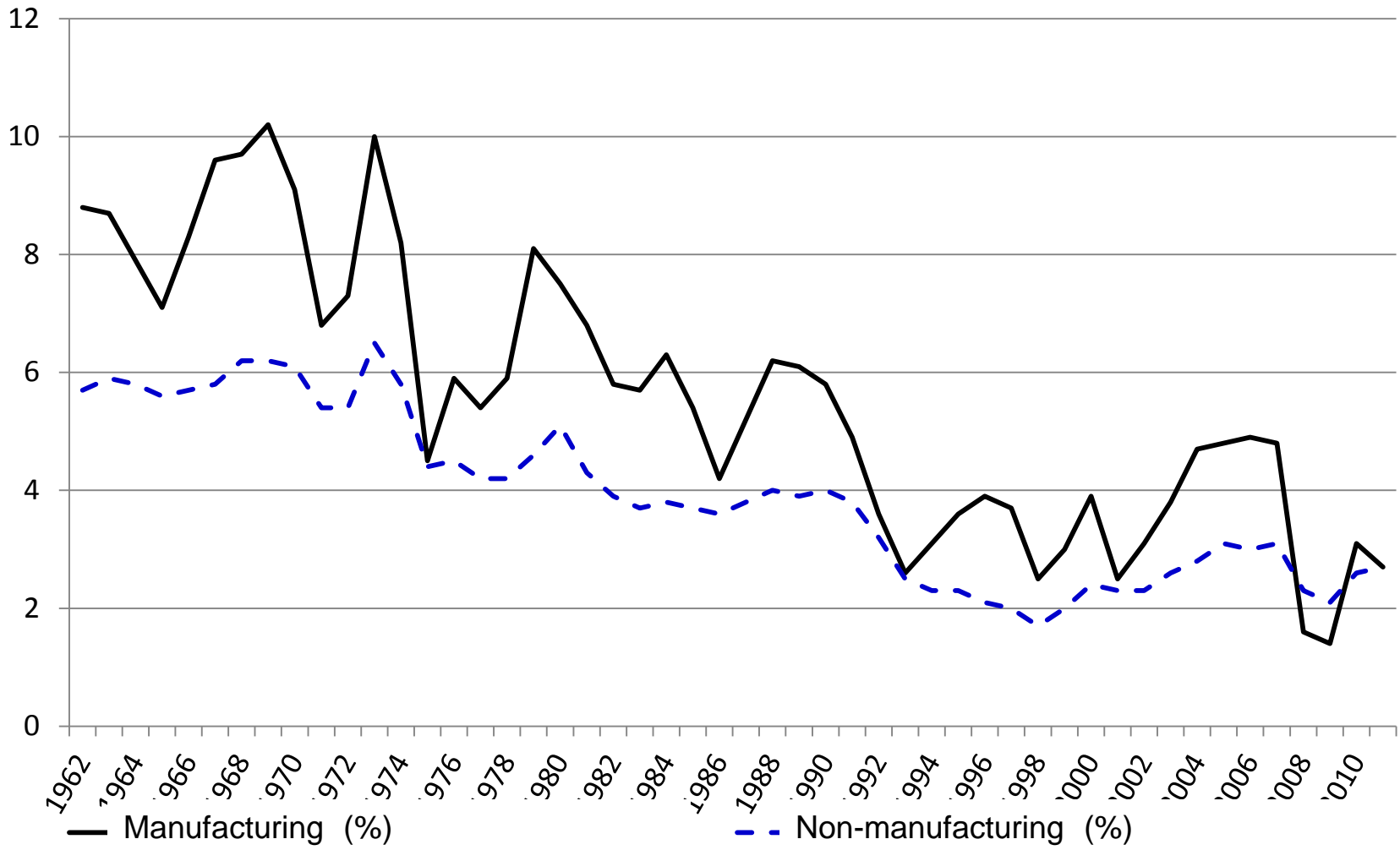
As presented above, the influence of legal systems on the behavior of enterprises is a serious issue for Japanese economic society. We must present relevant information based on an accurate analysis to enable broad discussions by relevant parties. To this end, I have conducted a comparative analysis of Japanese enterprise law with its US and German counterparts, and studied influence of these differences on the behavior of Japanese enterprises.

The hypotheses that I have presented in this paper are the first footholds to proposing a comprehensive reform of Japanese enterprise law, if they are confirmed as actual phenomena. I believe this confirmation should be based on a functional approach to examine how and to what extent the legal mechanism in practice influence the behavior of enterprises, not via an abstract model analysis or a partial value judgment.

I hope that further research and widespread constructive discussions will occur without delay.

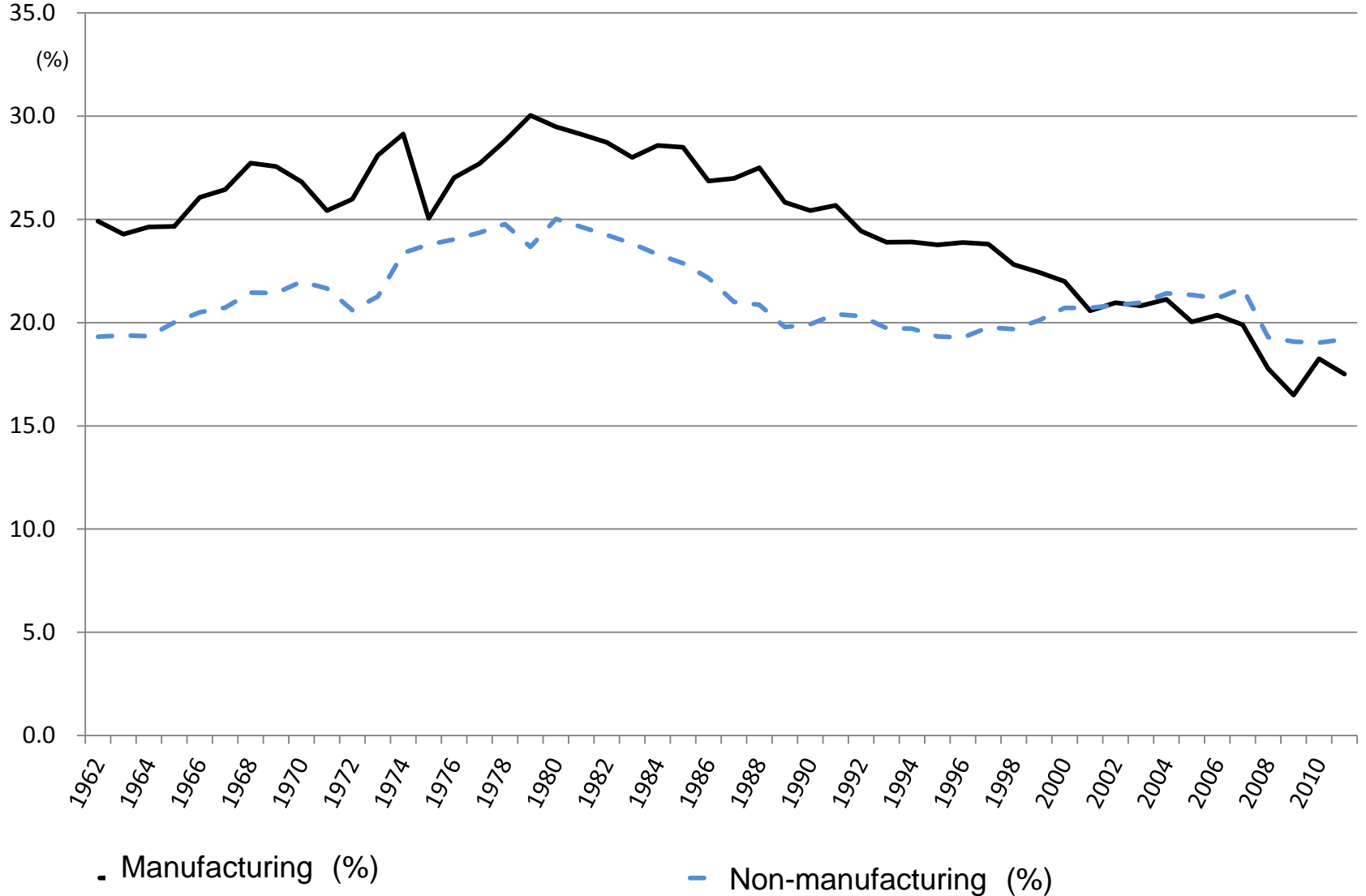
Legal Background to
the Low Profitability of Japanese Enterprises:
Explanatory Charts

1 Return on Assets of Japanese Enterprises



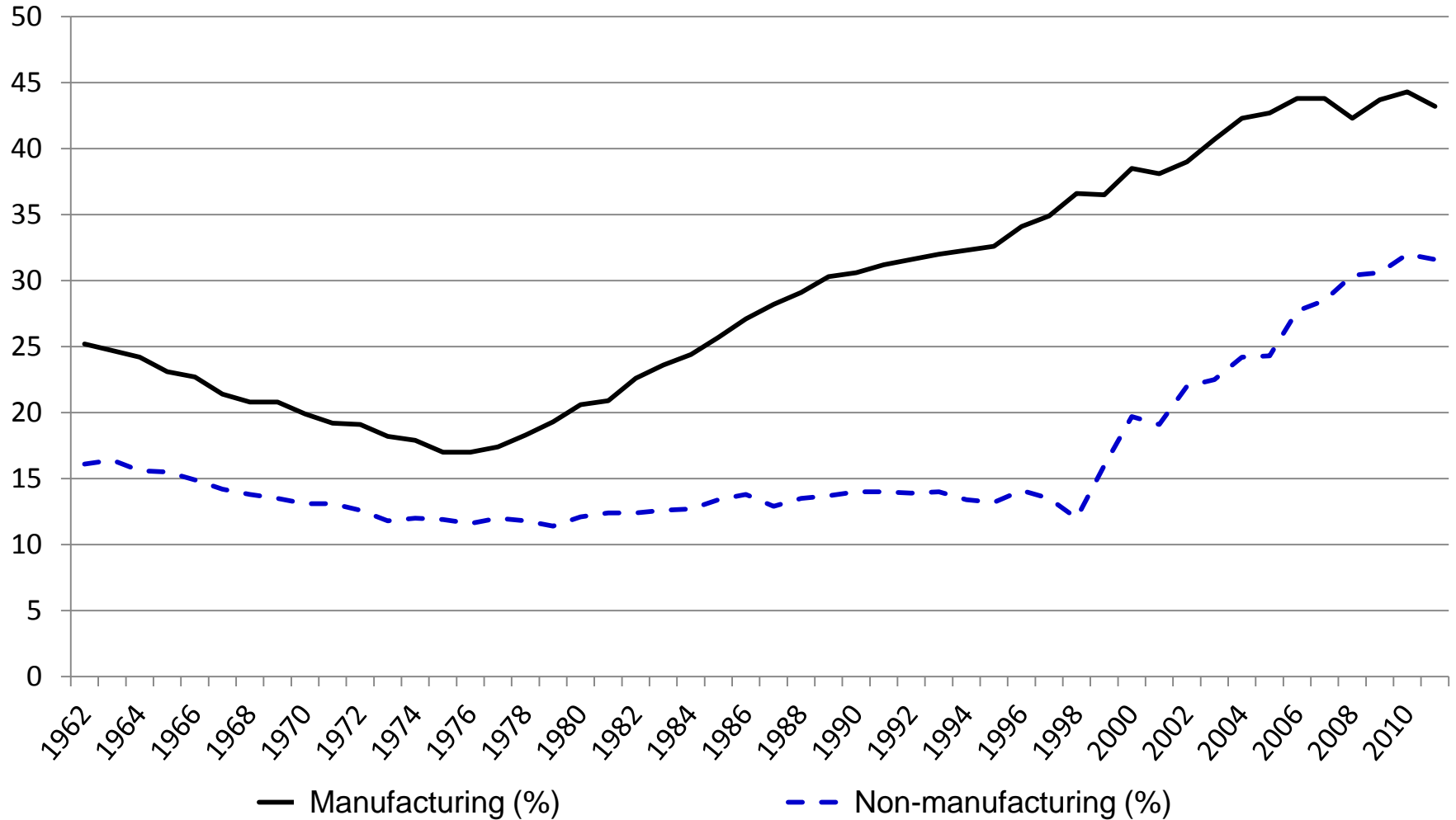
(Source) Ministry of Finance 'Financial Statements Statistics of Corporations'

2 Value Added per Asset Ratio of Japanese Enterprises



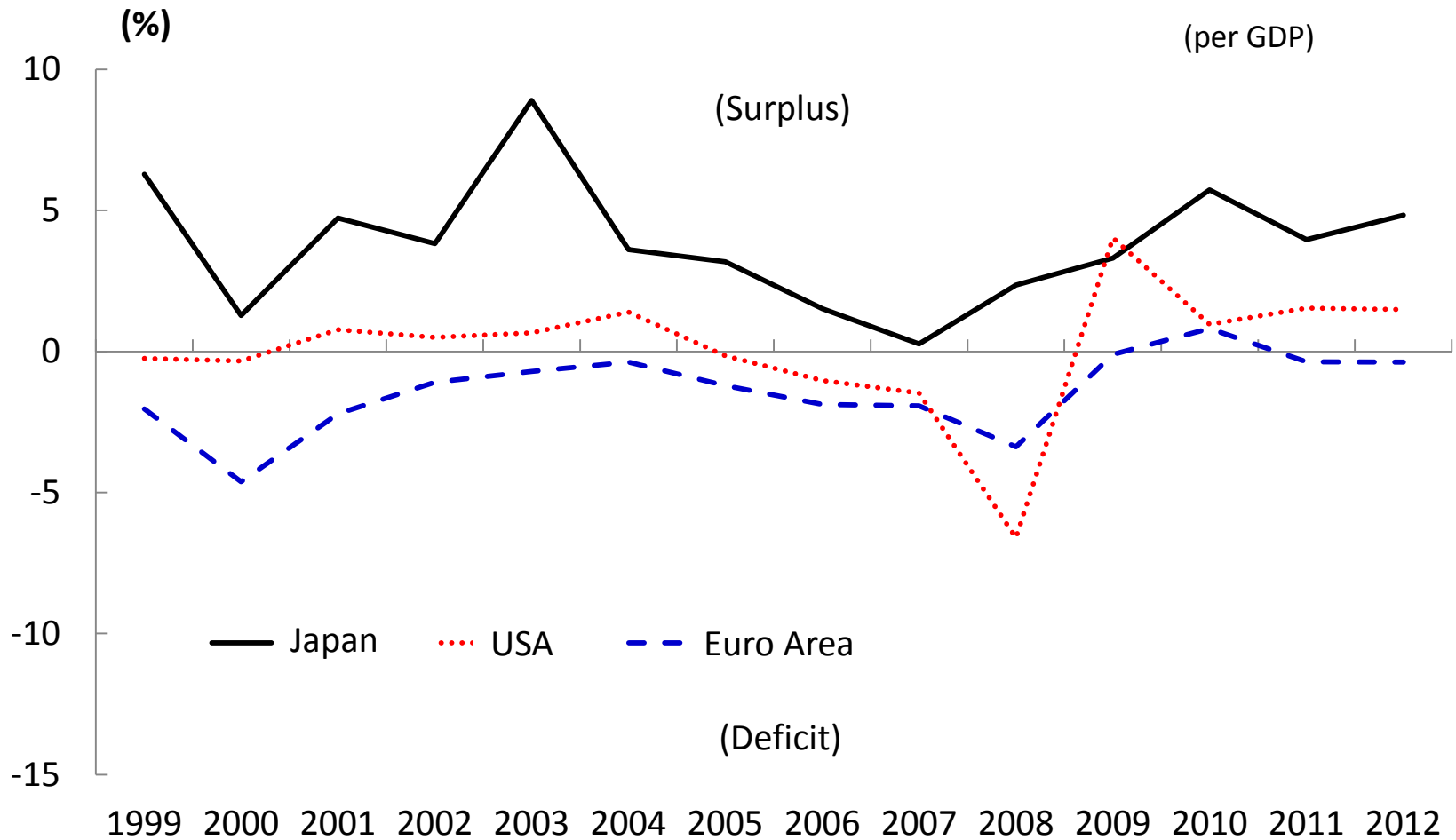
(Source) Ministry of Finance 'Financial Statements Statistics of Corporations'

3 Capital Asset Ratio of Japanese Enterprises



(Source) Ministry of Finance 'Financial Statements Statistics of Corporations'

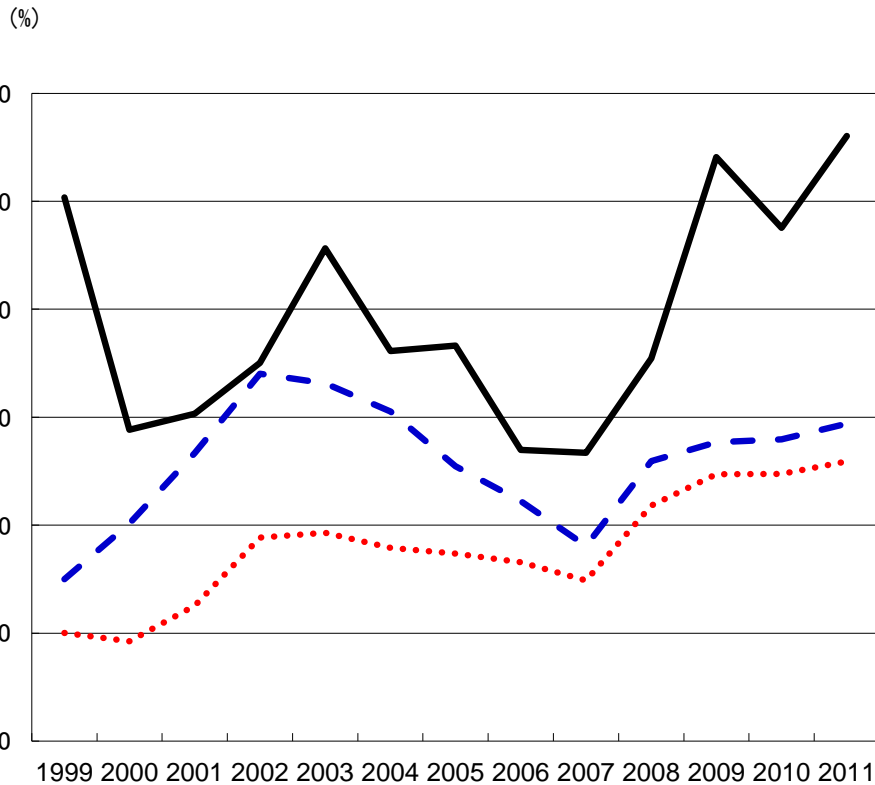
4 Cash Surplus and Deficit in the Corporate Sector



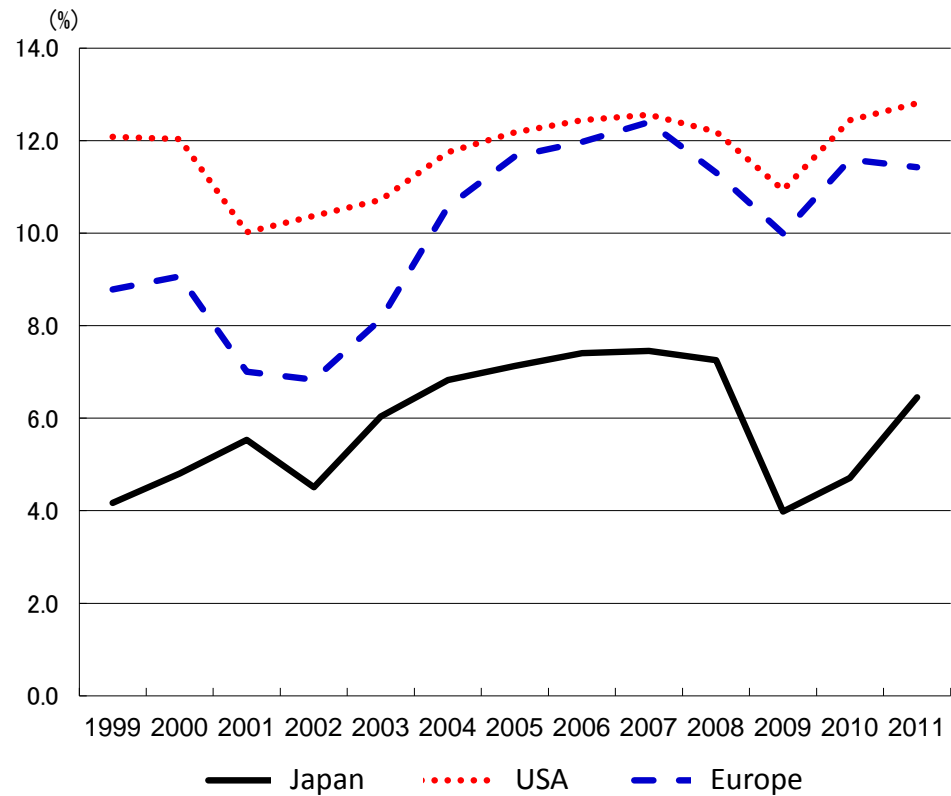
(Source) Bank of Japan 'Flow of Funds Statistics'

5 Financial Features of Listed Firms

Cash/Market Capitalization



Operational Profit



(Source) Mizuho Securities Management Research Department

6 Operation Profit Rates after the Deduction of Long-term Interest Rates

(%)

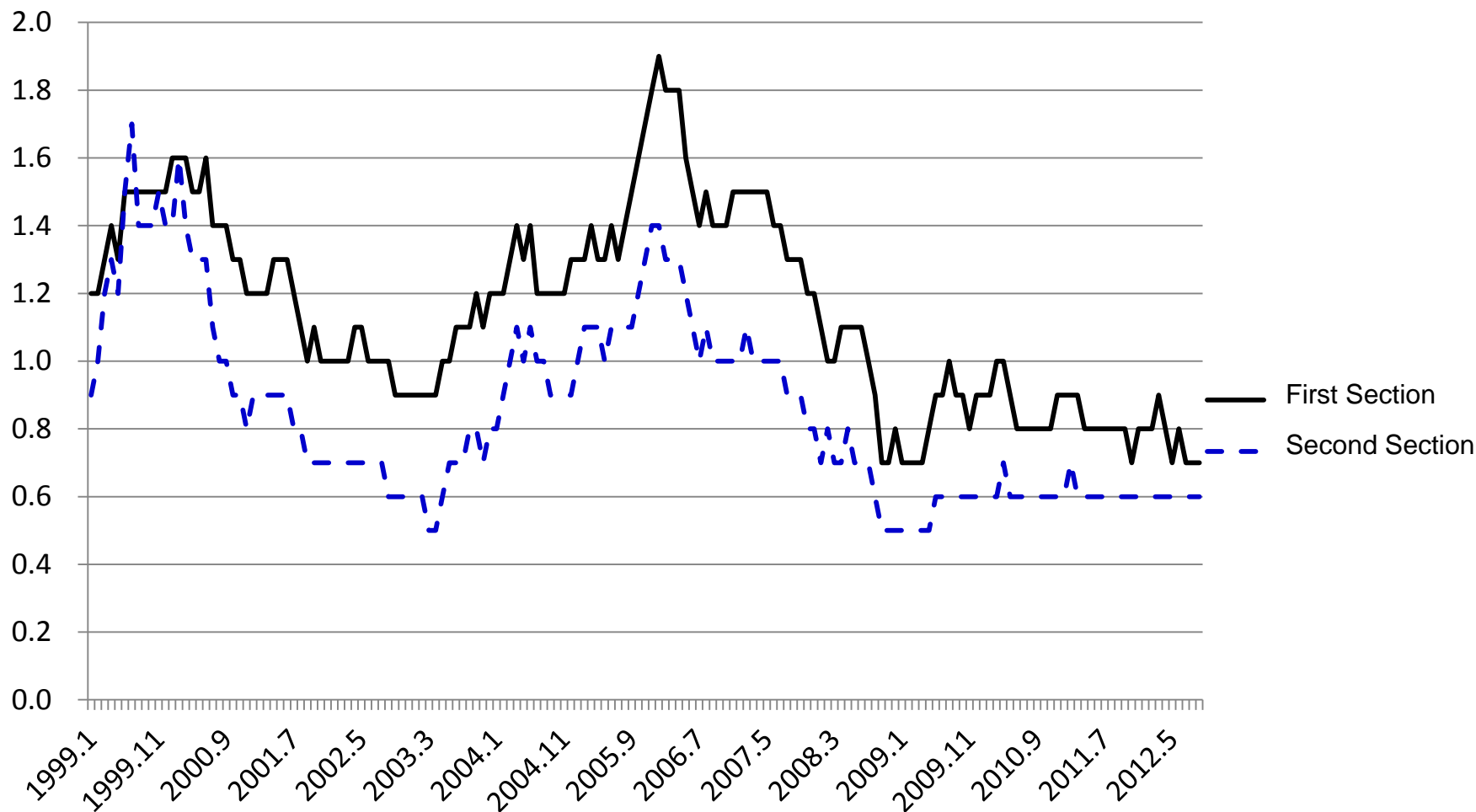


(Notes) 1 Operation Profit Rates minus 10-year Government Bond Yields.

2 Yield of German Government Bonds in Europe.

(Source) Operation Profit Rates: Mizuho Securities Management Research Department
Bond Yields: Japan Mutual Securities, Bloomberg

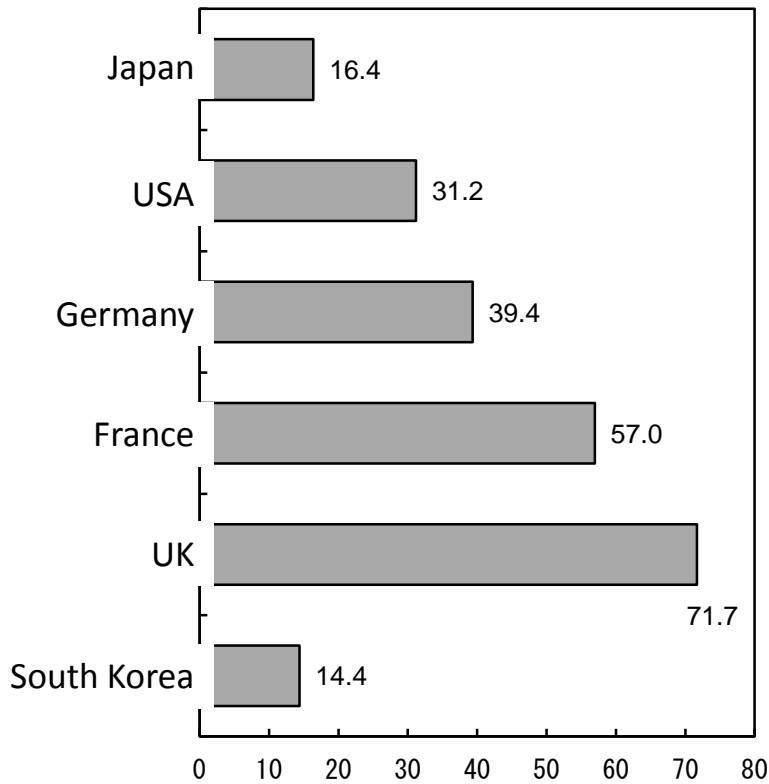
7 Price Book-Value Ratios in Tokyo Stock Exchange



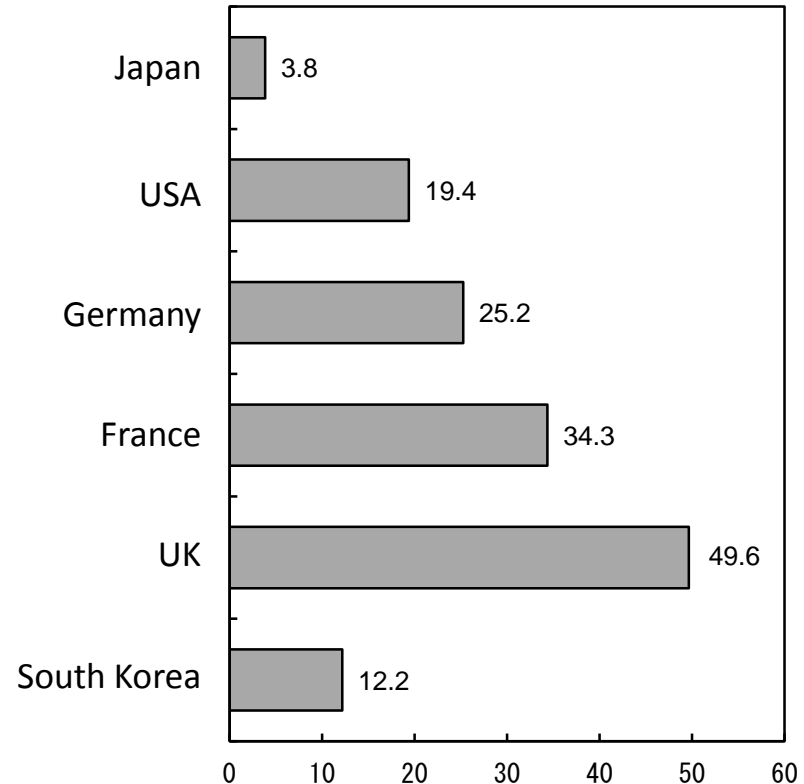
(Source) Tokyo Stock Exchange

8 Foreign Direct Investment per GDP

Outward FDI



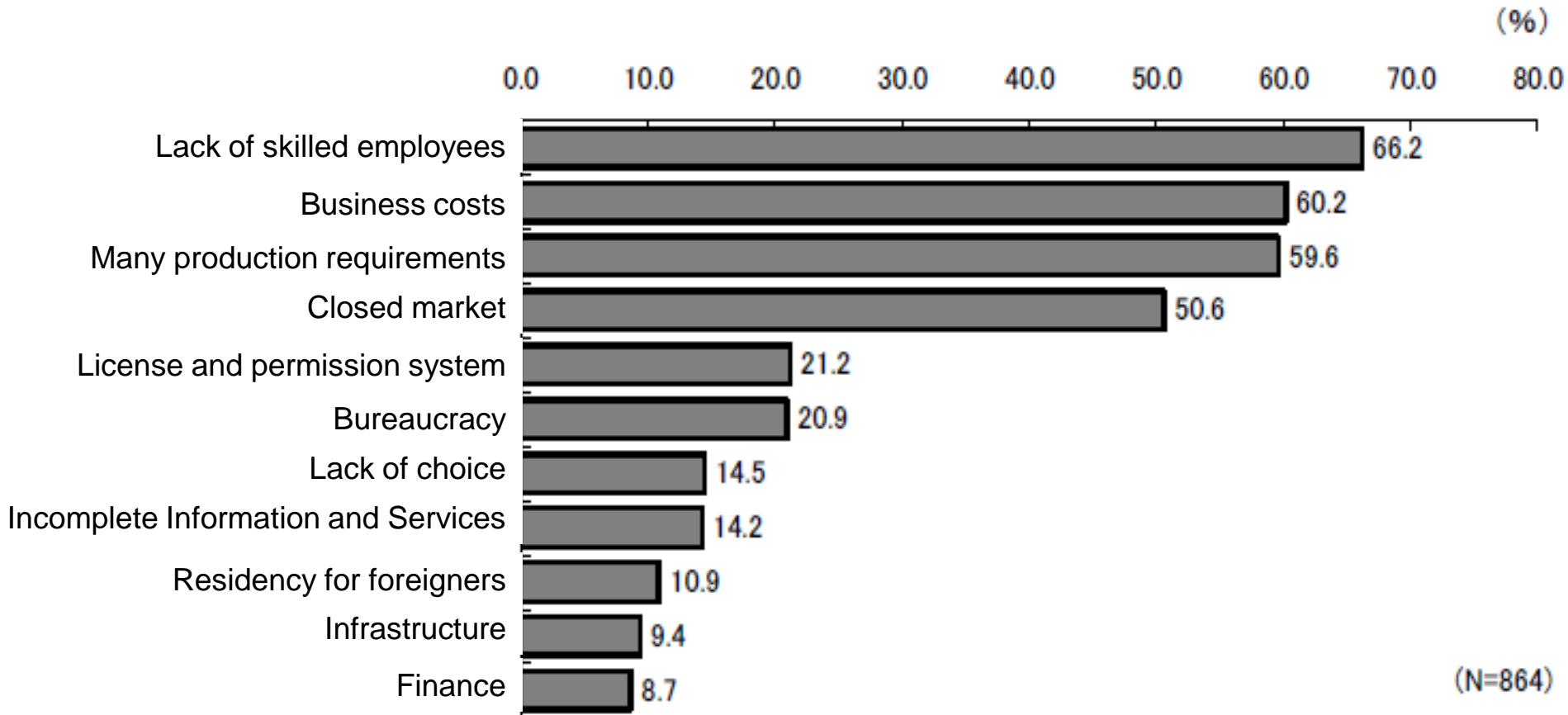
Inward FDI



(End of 2011, Per GDP, %)

(Source) OECD 'Foreign Direct Investment: Outward and Inward Stocks'

9 Obstacles for Foreign Enterprises in Japan



(Source) 'Survey of foreign enterprises' recognition' by Japan External Trade Organization (March 2008)

10 Comparison of Reorganization in Bankruptcy

	United States	Germany	Japan
Requirement to file	None	Insolvency, failure of payment and their likelihood	Insolvency, failure of payment and their likelihood
Duty to file	None	Balance sheet insolvency test (Civil and criminal liability)	None
Pre-package	Possible	Possible	Not allowed

(Note) Since autumn 2008, balance sheet insolvency can be ignored in Germany if a positive continuation prognosis can be made for a company.

In Japan, only financial institutions are obliged to apply for bankruptcy under the Deposit Insurance Act.

11 Bankruptcy Proceeding Rates

	2002	2003	2004	2005	2006	2007	2008	2009	2010
United States (Chapter 11)	10,823	9,762	10,882	6,250	5,701	4,688	6,274	10,348	13,583
Germany (Insolvenzordnung)	20,470	22,030	22,830	22,208	22,250	19,575	20,404	23,215	22,432
Japan (Bankruptcy)	8,026	7,763	7,281	8,578	8,756	9,914	11,676	11,844	11,096
(Reorganization)	889	856	551	592	536	601	906	716	529

(Sources) USA: United States Courts 'Bankruptcy Statistics'

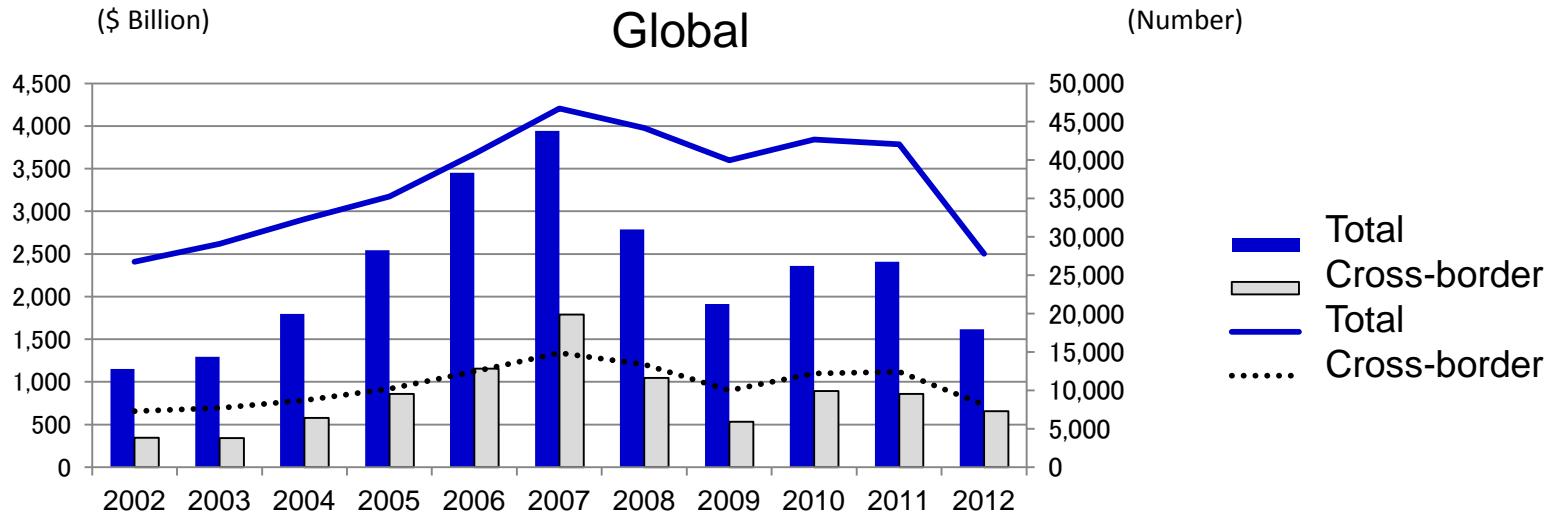
Germany: Schultze & Braun 'Insolvency and Restructuring in Germany'

Japan: Teikoku Data Bank

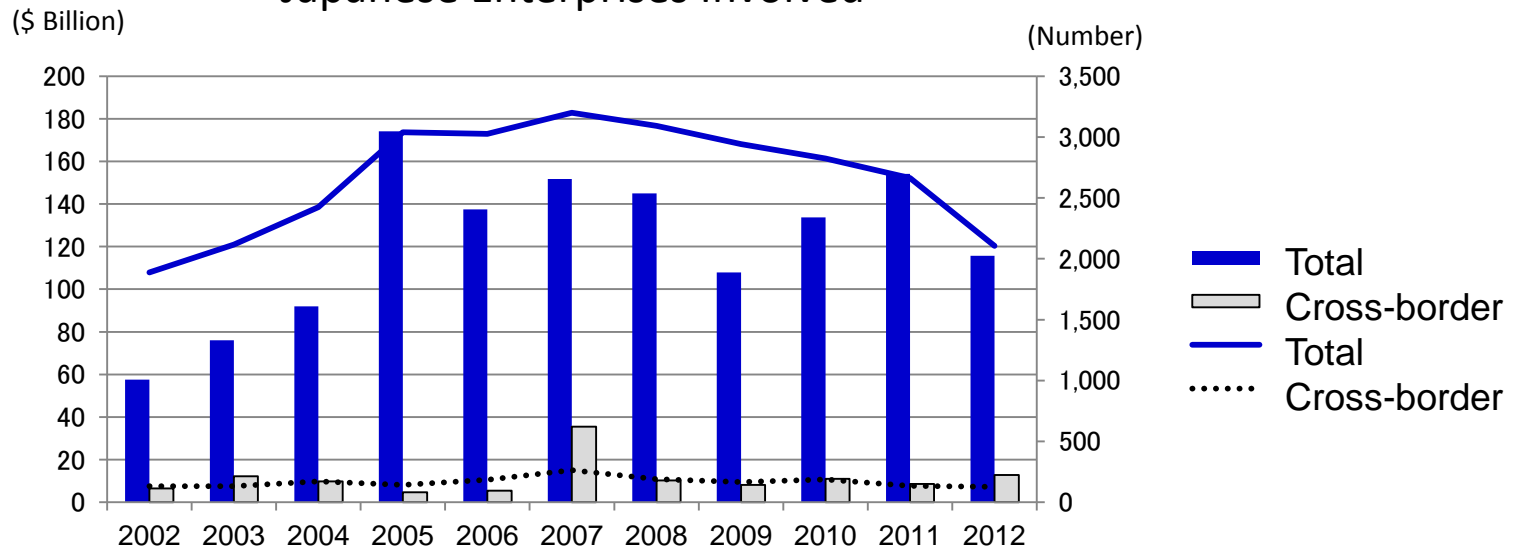
12 Comparison of Take-over Regulations

	United States	Germany	Japan
Take-over bidder			
Intent of the regulation	Ensure transparency in the case of a take-over bid	Protection of the minority in the case of a control shift	Protection of investors in the case of large transactions
Obligatory tender offer	Decided by SEC (a purchase of more than 5% must be reported)	Purchase by the block holder (more than 30%)	Purchase of more than 5% outside the exchange, or more than two-thirds by just a few shareholders
Mandatory bid	None	Yes (threshold of 30% ex-ante)	Yes (threshold of two thirds ex-post)
Price	Best-price rule	Equitable price (examined by the regulator)	Equal Treatment
Target Enterprise			
Duty of management	Revlon duty	Duty of neutrality (with certain exemptions)	General duty
Take-over defense	Unocal standard	Permit by supervisory board (interest of the enterprise)	Guideline for the take-over Defense

13 Volume and Number of M&A Transactions

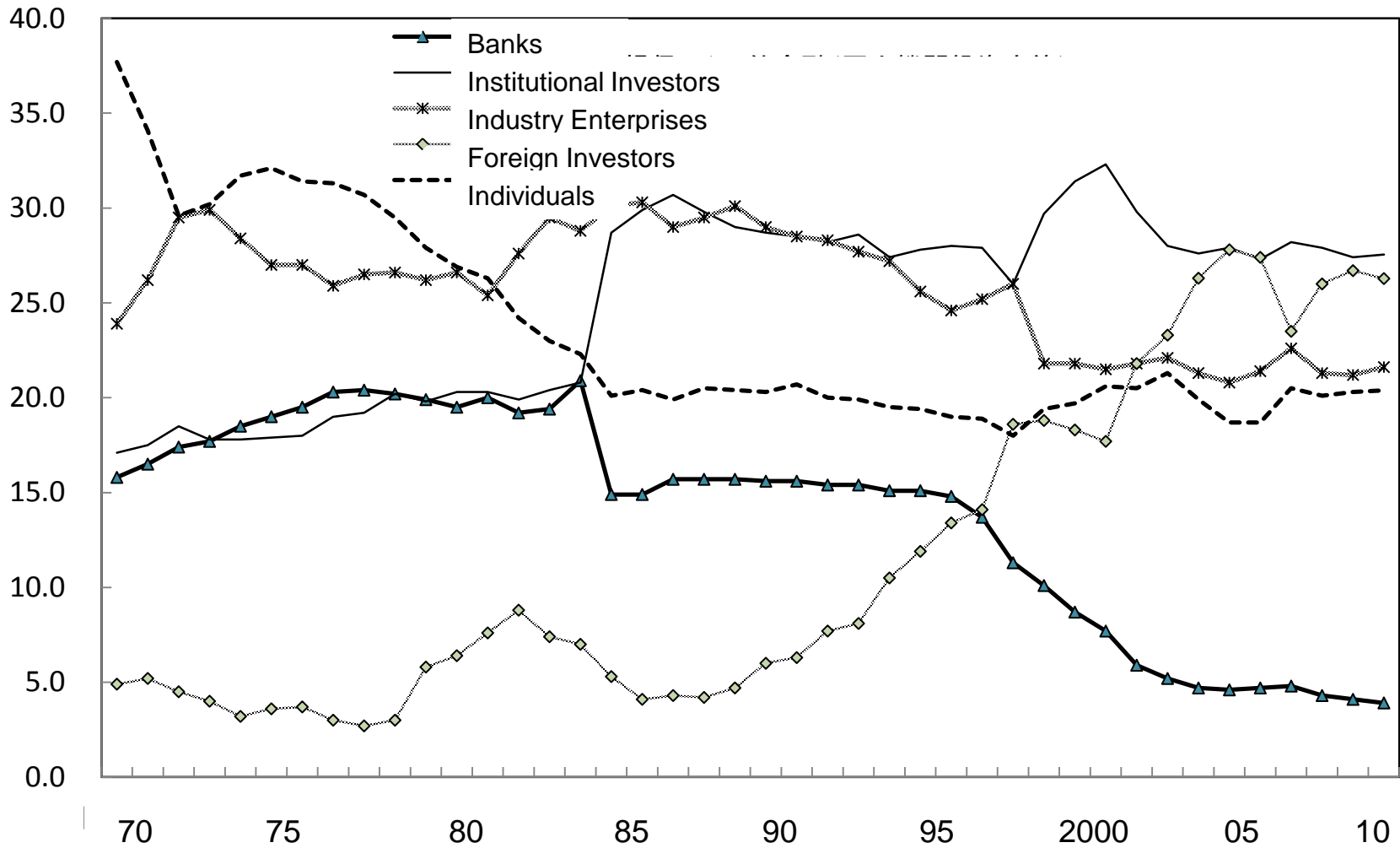


Japanese Enterprises Involved



(Source) Thomson ONE

14 Shareholdings by Investor-type



(Note) Includes the stocks of JASDAC from 2004 until 2009.

(Source) Tokyo Stock Exchange

15 Management's View of Stable Shareholders

		Number of Answers %								
Capital	Answer rate	10%- 19%	20%- 29%	30%- 39%	40%- 49%	50%- 59%	60%- 100%	Other	Did not Answer	Total
	Less than 10 billion	8.0 (0.6)	32.0 (2.2)	103.0 (8.7)	209.0 (16.1)	319.0 (26.8)	381.0 (36.7)	74.0 (7.4)	22.0 (1.5)	1148.0 (100.0)
10-100 billion	29.0 (7.4)	55.0 (13.5)	124.0 (21.7)	122.0 (18.2)	133.0 (19.0)	83.0 (12.5)	31.0 (4.4)	19.0 (3.2)	596.0 (100.0)	
More than 100 billion	9.0 (8.9)	27.0 (26.7)	22.0 (21.8)	6.0 (5.9)	10.0 (9.9)	4.0 (4.0)	10.0 (9.9)	13.0 (12.9)	101.0 (100.0)	
Total	46.0 (2.5)	114.0 (6.2)	249.0 (13.5)	337.0 (18.3)	462.0 (25.0)	468.0 (25.4)	115.0 (6.2)	54.0 (2.9)	1845.0 (100.0)	

(Source) 'Shoji Houmu'

16 Comparison of Investor Litigation Systems

	United States	Germany	Japan
Common trigger	Financial statement Share price	Information for shareholders	News, Regulator's measure
Information for litigation	Discovery	Independent evidence assessment	Ex-ante Evidence collection
Popular form of litigation	Securities suit (Shareholder derivative suits)	Shareholders' lawsuit	Shareholder derivative suits
Collective litigation	Class action (Opt-out)	Modeled Investor proceedings	--
Popular exit	Reconciliation	Judgment	Judgment

17 Comparison of Capital Market Regulators

	United States	Germany	Japan
	Securities and Exchange Commission	Bundesanstalt fuer Finanzdienstleistungsaufsicht	Securities and Exchange Surveillance Commission
Resource			
Staff	3750	(350)	700
Expenditure	1.2 billion dollars	27 million Euro	(6 billion Yen)
Finance	Independent	Independent	Government Budget
Enforcement			
Criminal charge	No	Yes	Yes
Civil penalty	Yes	Yes	Yes (Recommendation to The Financial Service Agency)
Civil lawsuit	Yes (Including Disgorgement)	No	No
Additional Authority			
Rule making	Yes	No	No
Assessment of TOB	No	Yes	No

(Source) 2011 Annual Reports (number of SEC and Bafin staff). 2012 Government Budget for SESC.

(Note) Staff numbers of Bafin and expenditure of SESC are based on percentage totals.

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