

Panacea or Placebo? An Empirical Analysis of the Effect of the Japanese Committee System Corporate Governance Law Reform

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I. INTRODUCTION

On two significant occasions in its modern history, Japan has undertaken law reform on a massive scale and at a blistering pace. In the 1850s, Japan embarked on the Meiji Restoration and achieved in thirty years a level of industrial development it had taken Western powers nearly a century to attain.¹ Beginning in the 1950s, postwar Japan transformed itself from a nation bombed into third world status into the economic envy of the world only a few decades later.²

Over the past fifteen years Japan has been attempting to repeat this feat. The collapse of the Japanese economy in the early 1990s and its stagnation for the “Lost Decade”³ has spurred rapid and extensive corporate law reform. In the field of corporate governance, a number of

¹ MARIUS JENSEN, *THE EMERGENCE OF MEIJI JAPAN* (1995).

² JOHN DOWER, *EMBRACING DEFEAT: JAPAN IN THE WAKE OF WORLD WAR II* (1999).

³ See generally Curtis Milhaupt, *A Lost Decade for Japanese Corporate Governance Reform?: What’s Changed, What Hasn’t, and Why* (Colum. L. School Center for Law and Econ. Stud., Working Paper No. 234, 2003); see also Luke Nottage & Leon Wolff, *Corporate Governance and Law Reform in Japan: From the Lost Decade to the End of History?* (Comparative Research in Law & Political Econ., Research Paper No. 3, (2005).

these reforms fill the gaps left by the decline of traditional monitoring mechanisms.⁴ Some commentators argue that the nature of these replacement mechanisms signals a shift toward a U.S. style corporate governance environment.⁵ A significant step in that direction was the enactment in 2002 of legislation giving large corporations the option of adopting a U.S.-style committee corporate governance structure. The committee system requires a corporation to establish committees for audit, remuneration, and nomination within its board of directors.

In the months before and after the introduction of this legislation, international and domestic corporate law experts analyzed the committee system and speculated about its likely impact on Japanese corporate governance.⁶ Enough data is now available to make a preliminary assessment of the impact of the committee system law reform. This paper examines the literature speculating on the committee system and assesses the actual impact of the new system in improving Japanese corporate governance. It isolates key issues of the committee system and evaluates the impact of the committee system relative to the reform as a whole. The conclusions of this assessment are then weighed against empirical research collected on the operational committee system.

This article refines the current understanding of the impact of the committee system on the Japanese corporate governance environment. This necessarily involves analysis and application of the theory underpinning corporate governance law and practice. This paper identifies how the committee system affects the work of business professionals working in Japanese industries indirectly charged by regulatory theory and the market with implementing and evaluating the reform. The earlier theoretical analysis is then assessed against the empirical results to achieve a better understanding of the effect of the committee system in practice. This article seeks to assist corporations and other parties in making informed decisions about corporate governance issues in Japan. Finally, this article briefly explores possible areas for further reform to the

⁴ See Ronald Gilson & Curtis Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343, 347-352 (2005); see also Dan Puchniak, *The 2002 Reform of the Management of Large Corporations in Japan: A Race to Somewhere?*, 5 AUSTL. J. ASIAN L. 42, 48-49 (2003).

⁵ See generally Daniel Kelemen & Eric Sibbit, *The Americanization of Japanese Law*, 23 U. PA. J. INT'L ECON. L. 269 (2002); see also Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 455-56 (2000-2001).

⁶ See, e.g., Gilson & Milhaupt, *supra* note 4; Puchniak, *supra* note 4; Kenjiro Egashira, *The Duties of Directors of Japan's Publicly Held Corporations, with an Emphasis on Supervisory Issues*, 17 J. JAPANESE L. 17, 21 (2004).

committee system law and improvements to committee system implementation.

The results of the empirical research suggest that adopting the committee system itself does not have a net positive or net negative effect on a corporation's performance. The cumulative effect of individual factors in a given corporation's case is more important. Nevertheless, the reform is having an impact at a macro level by forcing even non-adopting firms to reconsider their corporate governance situations.

In Part I of this article I explain the committee system reform in detail and place it in context with other recent corporate law reforms in Japan. In Part II explore and analyze the theoretical framework of the committee system framed by earlier research. In Part III I detail the conclusions of the empirical study regarding the committee system. This data demonstrates that, in practice, the success of adopting a committee system depends upon the manner in which it is utilized by individual companies. Finally, in Part IV I conclude that the operational committee system currently provides few advantages over the statutory auditor system. This section also briefly addresses areas for possible reform of Japanese corporate law.

II. PART I: CONTEXT AND BACKGROUND

In late 19th Century Japan, there was a growing perception among then modern managers that the job of a corporate director was "nothing but coming to the office daily, reading newspapers, and passing his time gossiping."⁷ The view developed that directorial posts should be filled by executives, and as a result non-executive monitoring directors gradually disappeared from the Japanese corporate scene.⁸

The Commercial Code, enacted in 1899,⁹ and corporate governance practice over the following century reflected and perpetuated

⁷ See Egashira, *supra* note 6, at 19 (citing Tsunehiko Yui, *Nihon ni okeru jūyaku soshiki no henshin* [Changes in Executive Organization in Japan], 24 KEIEI RONSHŪ [J. BUS. ADMIN.] 30 (1979)).

⁸ Egashira, *supra* note 6, at 18-19.

⁹ Shōhō [Commercial Code], Law No. 48 of 1899 (hereinafter Commercial Code). In 2005, Part 2 of the Commercial Code, which dealt with the law of corporations, was spun off into the new Kaishahō [Corporations Act], Law No. 66 of 2006 (hereinafter Corporations Act). The Corporations Act passed the Diet in 2005 but did not come into effect until 2006. An executive director is a director who, in some capacity, engages in the day-to-day management of the company. In reality, executive directors will also monitor the actions of the company's other directors and executives. A non-executive director's role is generally confined to monitoring the actions of the company's executives and the other directors, and does not involve any day-to-day management.

the philosophy that directors should also be executives. The original Commercial Code introduced the statutory auditor system, a weak counterpart to the German supervisory board.¹⁰ Under that system, a statutory auditor is appointed by shareholders' resolution¹¹ and has no power to appoint or remove directors.¹² A statutory auditor's sole functions are to audit the company's financial statements and monitor the board of directors' compliance with the law.¹³ Recent amendments to the Commercial Code have strengthened the monitoring ability of the statutory auditor by requiring large corporations¹⁴ to have a board of at least three auditors—at least half of whom must be outside auditors¹⁵—and extending the term of office and the responsibilities of the auditors.¹⁶ Japanese corporate law has never mandated outside directors for companies that use statutory auditors.

In lieu of a robust internal monitoring system mandated by statute, the Japanese corporate environment in practice developed unique monitoring mechanisms that effectively eliminated the need for non-executive directors.¹⁷ Large corporate groups, known as keiretsu, created

¹⁰ HARALD BAUM, *MARKTZUGANG UND UNTERNEHMENSERWERB IN JAPAN [MARKET ACCESS AND ACQUISITION OF COMPANIES IN JAPAN]*, 169 (1995). Baum explains that the Japanese statutory auditor is weaker than the German supervisory board because: (a) in contrast to the statutory auditor the supervisory board has the power to nominate and dismiss members of the board of directors, and (b) the supervisory board monitors the appropriateness of directors' actions as well as the legality.

¹¹ Corporations Act, art. 329.

¹² Corporations Act, arts. 339-40.

¹³ Corporations Act, art. 381, para. 1. There is debate as to whether the duties of the statutory auditor extend to monitoring the appropriateness of the directors' actions in addition to their legality. The common interpretation is that they are limited to monitoring legality; see HIDEKI KANDA, *KAISHAHŌ [CORPORATIONS LAW]* 78, 200 (2006).

¹⁴ A large corporation is a corporation with stated capital of more than 500 million yen, which is approximately \$5 million (Australian) dollars, or total liabilities of more than 20 billion yen, which is approximately \$200 million (Australian) dollars. Corporations Act, art. 2, para. 6.

¹⁵ *KABUSHIKI GAISHA NO KANSA TŌ NI KAN SURU SHŌHŌ NO TOKUREI NI KAN SURU HŌRITSU [Act on Special Provisions of the Commercial Code Concerning Audits]*, Law No. 22 of 1974, amended by Law No. 44 of 2002, art. 18, para. 1. This provision has been superseded by Corporations Act, art. 335, para. 3.

¹⁶ Commercial Code, art. 273, para. 1 (permitting a four-year term); Commercial Code, art. 260-3, para 1 (requiring auditors to attend meetings of the board). These provisions have been superseded by Corporations Act, arts. 336, para. 1 and 383, para. 1, respectively.

¹⁷ Gilson & Milhaupt, *supra* note 3, at 350-51.

extensive cross-shareholdings and reciprocal directorships.¹⁸ This removed the market for corporate control and allowed managers to take a long-term view.¹⁹ The result was a culture of lifetime employment that granted all employees a strong interest in the company's future.²⁰ Even today, the boards of many 'blue chip' companies such as Toyota, Canon, and Mitsubishi consist of representatives from each of the company's business groups who have spent their entire careers climbing the corporate ladder.²¹ These internal monitoring systems were reinforced by a main bank acting as the principal lender and typically the largest shareholder of group companies.²²

The resulting corporate governance framework has been described as the "zenith of efficient managerial monitoring."²³ Agency costs resulting from the separation of ownership and management were virtually eliminated. Throughout the 1970s and 1980s the success of this monitoring system was demonstrated year after year as corporate profits rocketed ever higher.

These internal monitoring mechanisms began to collapse, along with the Japanese economy, in 1991. Faced with the burden of extensive bad loans, main banks could no longer stand behind corporate managers.²⁴ Management, in turn, began to sell off cross-shareholdings to free up much-needed cash. As the stability of Japan's corporate governance framework stumbled, even lifetime employment was no longer secure. In

¹⁸ Ronald Gilson & Mark Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization* 102 YALE L.J. 871, 882-84 (1993).

¹⁹ Puchniak, *supra* note 4, at 46-47.

²⁰ *Id.*

²¹ Christina Ahmadjian, *Changing Japanese Corporate Governance* (Columbia Univ. Ctr. on Japanese Econ. & Bus., Working Paper No. 188, 2001) 16; see also TOYOTA MOTOR CORP., YAKUIN ICHIRAN [ICHIRAN] [LIST OF OFFICERS] (2006), http://www.toyota.co.jp/jp/ir/library/annual/pdf/2006/p50_51.pdf (last visited Oct. 16, 2006); CANON INC., YAKUIN ICHIRAN [ICHIRAN] [LIST OF OFFICERS] (2006), <http://web.canon.jp/corp/executive.html> (last visited Oct. 16, 2006); MITSUBISHI CORPORATION, CORPORATE OFFICERS (2006), <http://www.mitsubishicorp.com/en/about/bmembers/index.html> (last visited Oct. 16, 2006).

²² MASAHIKO AOKI & HUGH PATRICK, *THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES* (1994). Note, however, that Egashira plays down the monitoring role of main banks. Egashira, *supra* note 6, at 20.

²³ Puchniak, *supra* note 4, at 46.

²⁴ Gilson & Milhaupt, *supra* note 4, at 351.

response, the Japanese government began the corporate law reform of the past decade to facilitate the corporate restructuring necessary in Japan's new economic reality.²⁵

A. *The Committee System*

In May 2002, the National Diet of Japan passed legislation amending the Commercial Code to allow for the committee system corporate governance structure.²⁶ However, in a “characteristically unusual”²⁷ fashion, the Diet set up the committee system as an optional alternative to the existing statutory auditor system. The legislation was the result of a compromise between the Ministry of Justice and the business community. The Ministry of Justice initially proposed to replace the statutory auditor system with three mandatory committees under the board of directors and require all large corporations to have at least one outside director. The business community opposed this proposal on the grounds that: (a) no single board structure should be legislatively mandated, and (b) companies should not be forced to have outside directors.²⁸

Under the new law, if a company elects to adopt the committee system in lieu of the statutory auditor it must appoint three committees for audit, nomination, and remuneration.²⁹ Each committee must consist of at least three directors and a majority of the directors in each committee must be outside directors.³⁰ However, the same outside director may sit on all three committees.³¹ Companies that opt not to adopt the committee-system retain the statutory auditor system and are not required to have any outside directors. The committee system reform also strengthens the separation of monitoring and execution by requiring adopting companies

²⁵ *Id.*

²⁶ SHŌHŌ TŌ NO ICHIBU WO KAISEI SURU HŌRITSU [Act Partially Amending the Commercial Code], Law No. 44 of 2002. The amended legislation came into effect on Apr. 1, 2003. The provisions of the Commercial Code relating to the committee system have since been superseded by the Corporations Act.

²⁷ Gilson & Milhaupt, *supra* note 4, at 344.

²⁸ *Id.* at 353-54.

²⁹ Corporations Act, art. 2, para. 12.

³⁰ Corporations Act, art. 400.

³¹ It is not necessary for a majority of the directors on the board of a company with the committee system to be outside directors. For example, if each of the three committees comprises the mandatory minimum of three directors and the same two outside directors serve on all three committees, then the minimum number of outside directors required on the board of directors as a whole is two. If the board as a whole consisted of five or more directors then the outside directors would be in the minority.

to appoint executive officers, including at least one representative executive officer (i.e., a chief executive officer or CEO).³²

B. Data on Committee System Adoption

Companies adopt the committee system by amending their certificates of incorporation. This amendment requires the approval of shareholders and is usually made at an annual shareholders' meeting. Seventy-one companies moved to the committee system in the first round of adoptions in 2003.³³ As of October 2006, another thirty-nine companies have adopted the committee system.³⁴ The total adoption figure of 110 companies is partially misleading because it includes Nomura Holdings with its thirteen privately held subsidiaries and Hitachi Ltd. with its twenty-one affiliate companies.³⁵ Aggregating these subsidiaries and affiliates, the total number of adoptions reduces to seventy-six companies.³⁶

Compared to the hundreds of thousands of companies in Japan,³⁷ the number of companies that have adopted the optional committee system so far is low. However, it is significant for a number of reasons. First, the initial uptake was exponentially larger than commentators had predicted.³⁸

³² See Corporations Act, art. 402.

³³ JAPAN CORPORATE AUDITORS ASS'N, IINKAI SECCHI KAISHA—IKŌ KAISHA RISUTO [COMMITTEE SYSTEM COMPANIES—LIST OF ADOPTING COMPANIES] (2006) http://www.kansa.or.jp/PDF/iinkai_list.pdf (last visited July 26, 2006).

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ At the time of the 2004 national census, there were 693,683 stock companies in Japan. STATISTICS BUREAU, RESULTS OF INCORPORATED ENTERPRISES FOR JAPAN (2004) JAPAN MINISTRY OF INTERNAL AFFAIRS AND COMM., <http://www.stat.go.jp/english/data/jigyoku/2004/kigyoku/index.htm> (last visited Oct. 16, 2006). The proportion of adopting companies increases significantly if you consider only listed companies. Of the 2,323 domestic companies listed on the Tokyo Stock Exchange, 62 have moved to the committee system. TOKYO STOCK EXCHANGE, TOKYO STOCK EXCHANGE FACT BOOK 2006 (2006), http://www.tse.or.jp/english/market/data/factbook/fact_book_2006.pdf (last visited Oct. 16, 2006). Of the 970 companies listed on the JASDAQ exchange, eight have moved to the committee system. JASDAQ SECURITIES EXCHANGE, MONTHLY STATISTICS OF THE JASDAQ MARKET 2006 (2006), http://www.jasdaq.co.jp/statistic/stat_2006_en.jsp.

³⁸ See, e.g., Miwa Suzuki, *Experts Doubt Many Firms to Follow Sony and Adapt U.S.-Style Structure*, AGENCE FRANCE-PRESSE (JAPAN), Jan. 29, 2003. This article identifies only two companies, Sony and Konica Minolta, that had confirmed plans to adopt the committee-system, and states that only 4.7% of companies on the Tokyo Stock Exchange were even considering a move to the new system.

Moreover, while not as high as when the legislation was first enacted, the adoption rate since 2003 has remained steady. Second, all of the adoptions have occurred in the wake of the Enron and WorldCom corporate governance scandals in the United States. Despite growing uncertainty about the effectiveness of the U.S.-style committee system, 110 Japanese companies have adopted a monitoring system modeled upon it. Finally, a considerable number of the companies that adopted the committee system are large, high-profile firms. In addition to the Nomura and Hitachi groups, Sony, Orix, Toshiba, Konica Minolta, Mitsubishi Electric, Kanebo, as well as Resona, Tokyo Star and Shinsei banks, Fidelity Securities and the JASDAQ Securities Exchange have all moved to the committee system.³⁹

III. PART II: THE GILSON AND MILHAUPT THEORETICAL FRAMEWORK

In light of the pessimistic predictions of commentators and the corporate governance scandals in the United States, it is logical to ask *why* many high profile companies moved to the committee system. In research conducted shortly after the first round of committee system adoptions, Columbia University Law Professors Ronald Gilson and Curtis Milhaupt examined a number of “strategies of choice” as possible explanations for a company’s decision to adopt the committee system.⁴⁰ The authors acknowledged that it was too early at that time to assess the success or failure of these strategies. Nearly four years later, this article empirically tests the effect of committee system adoption with reference to the strategies of choice put forward by Gilson and Milhaupt.

In the same study, Gilson and Milhaupt measured the effects on stock price of a company’s first public announcement of intention to adopt the committee system. They concluded that “average abnormal returns to announcements were negative but not statistically significant.”⁴¹ While recognizing the importance of stock price effects, this article assesses the committee system law reform by examining whether, and how, adoption of the committee system improves a company’s governance mechanisms. These internal factors are overlooked in an evaluation solely of stock price.

In this article I use flexibility and monitoring as criteria for my assessment. The committee system is viewed as improving corporate governance if it either enhances flexibility, thereby increasing the options

³⁹ JAPAN CORPORATE AUDITORS ASS’N, *supra* note 33.

⁴⁰ Gilson & Milhaupt, *supra* note 4.

⁴¹ *Id.* at 366.

available to management, or monitoring.⁴² In this article I also assess the committee system in its capacity to achieve a higher market valuation for a company.

In this section I isolate three key factors arising in Gilson and Milhaupt's strategies that potentially impact upon the effect of committee system adoption: outside directors, corporate groups, and industry. It additionally addresses the issues concerning executive officers—especially the CEO. I selected these four factors for analysis because they deviate considerably from the statutory auditor system, and are key aspects of a corporate governance structure that is supposed to be an improvement from the old system. In this section I critically assess these four areas of inquiry and reaches tentative conclusions as to the accuracy of the Gilson and Milhaupt study and how each issue contributes, or fails to contribute, to enhancing flexibility or monitoring. Part 4 then assesses these conclusions against the results of the empirical study detailed in Part 3.

A. *Outside Directors*

As explained earlier, a company with the committee system requires a majority of outside directors on each of its three committees.⁴³ In contrast, a statutory auditor company is not required to have any outside directors but may optionally appoint them. In this sense, the committee system reform strengthens the monitoring role of the board of directors by increasing the number and the influence of outside directors. However, this goal is undermined by the relatively weak definition of outside director.⁴⁴ According to Japan's Corporations Act, an outside director is a director who is not presently and has never previously been an executive director, an officer, or an employee of the company or a subsidiary of the company.⁴⁵ The result of this definition, as Tomotaka Fujita points out, is that the committee system can be used or abused in a number of different ways.⁴⁶ It may be used to enable strict monitoring of management by truly

⁴² Curtis Milhaupt groups the major reforms to Japanese corporate governance since 1993 according to whether they enhance flexibility or monitoring: Milhaupt, *supra* note 3, at 4-11. This dichotomy is also used by others. See, e.g., Arthur Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. SUPP. 317, 317 (1998).

⁴³ Corporations Act, art. 400.

⁴⁴ See, e.g., Gilson & Milhaupt, *supra* note 4; Puchniak, *supra* note 4, at 64; Egashira, *supra* note 6, at 23; Tomotaka Fujita, *Modernising Japanese Corporate Law: Ongoing Corporate Law Reform in Japan*, 16 SING. ACAD. L.J. 321, 339-40 (2004).

⁴⁵ Corporations Act, art. 2, para. 15.

⁴⁶ Fujita, *supra* note 44, at 340.

independent outside directors.⁴⁷ It may be used as a method for organizing the hierarchical structure of corporate groups.⁴⁸ Alternatively, a company may legally appoint family members, golf buddies, or old dormitory roommates as outside directors to ensure entrenchment of the incumbent management.⁴⁹ The effect of committee system adoption could vary considerably depending on which of the above kinds of outside directors are appointed.

In considering the effect of committee system adoption, Gilson and Milhaupt draw a comparison between Japan, and a South Korean corporate governance study demonstrating that the existence of outside directors tends to defeat a phenomenon known as “shareholder tunnelling” in South Korea, in other words the control of a company by majority shareholders at the expense of minority shareholders.⁵⁰ Gilson and Milhaupt point out that because Japan “is not characterized by controlling shareholder capital structures, Japanese firms are not subject to widespread controlling shareholder tunnelling.”⁵¹ Instead, Gilson and Milhaupt posit that Japanese companies may suffer from what they call “stakeholder tunnelling”—commitment by a company to maximizing something other than shareholder value.⁵² Especially in the period when keiretsu and main banks dominated Japan’s corporate monitoring mechanism, creditor and employee interests were usually placed ahead of shareholders’ interests.⁵³ Despite the similarities, Gilson and Milhaupt argue that the appointment of outside directors is unlikely to defeat stakeholder tunnelling in the same way that it has helped defeat shareholder tunnelling in South Korea. In other words, the committee-system is unlikely to improve the monitoring mechanisms of statutory auditor companies. Gilson and Milhaupt give two grounds for this view:

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* It is possible to appoint these kinds of outside directors in other countries as well, but the ratio of independent outside directors is usually very high. For example, in 2000, the proportion of all directors (not just outside directors) who were independent in U.S. S&P 500 corporations was 68.7 percent. Motomi Hashimoto, *Commercial Code Revisions: Promoting the Evolution of Japanese Companies* 12 (Nomura Research Institute, Working Paper No. 48, 2002).

⁵⁰ Gilson & Milhaupt, *supra* note 4, at 360.

⁵¹ *Id.* at 361.

⁵² *Id.*

⁵³ See Ronald Gilson & Mark Roe, *Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization* 102 *YALE L.J.* 871, 879-82 (1993).

(a) Japan's loose definition of outside director, and (b) they assert that stakeholder tunnelling is a cultural characteristic of Japan.⁵⁴

Gilson and Milhaupt first argue that the loose definition of "outside director" in Japan does not ensure that outside directors are divorced from the interests of controlling shareholders and other stakeholders.⁵⁵ However, the optional nature of the committee system works against this argument. Because the statutory auditor system does not require companies to appoint any outside directors, there appears to be little point in a company moving to the committee system if it intends to appoint non-independent outside directors. It may be, as Gilson and Milhaupt suggest, that there are reasons other than achieving stronger monitoring for adopting the committee system, such as a general signalling to the market. The strengthening of corporate groups is just one such possibility.⁵⁶

The appointment of outside directors who are not truly independent may not be as detrimental to the monitoring mechanisms of the committee system as Gilson and Milhaupt suggest. Dan Puchniak, professor of Japanese corporate law, argues that so-called "grey" directors are at least as effective as, or even more effective than, completely independent directors.⁵⁷ Puchniak argues that "what grey directors lack in independent monitoring they make up for in the incentive to monitor."⁵⁸ However, a greater incentive to monitor is meaningless if the interests grey directors seek to protect through their monitoring are more likely to be aligned with management than shareholders. Puchniak further argues that a grey director's relationship with the company or key officers in the company gives them access to better information which, in turn, increases their ability to monitor.⁵⁹ However, as Professor Kenjiro Egashira of the University of Tokyo, points out, this advantage may be largely nullified in Japan because many companies have directors who are neither executive officers nor outside directors according to the legal definition.⁶⁰ These

⁵⁴ Gilson & Milhaupt, *supra* note 4, at 361-62.

⁵⁵ *Id.*

⁵⁶ *Id.* at 364-65.

⁵⁷ Puchniak explains that, in the U.S. corporate model, outside directors are divided into two categories: grey directors, who have a material relationship with the company or its management, and independent directors, who have no material relationship with either the company or its management. Puchniak, *supra* note 4, at 65.

⁵⁸ *Id.*

⁵⁹ Puchniak, *supra* note 4, at 68-69.

⁶⁰ *Id.* at 64.

middle-ground directors commonly relay internal information to the outside directors.⁶¹

Gilson and Milhaupt secondly argue that stakeholder tunnelling is a cultural characteristic of Japan and consequently there will be little monitoring improvement.⁶² A simple solution to this problem would be to fill more outside director positions with foreigners who do not share the cultural commitment to stakeholder tunnelling. However, there is little evidence that this is happening.⁶³ Gilson and Milhaupt recognize that the appointment of outside directors “may turn out to be the hydraulics of change even if they are not its cause.”⁶⁴ Certainly the fact that a number of Japanese companies have voluntarily appointed outside directors, and that several did so before the committee system reform was introduced, suggests a growing understanding of a need to protect interests other than those usually advanced by management.⁶⁵ Sony, which has of its own accord appointed a majority of outside directors to its board, is an ideal example of this trend.⁶⁶ Moreover, other recent corporate law reforms indicate a growing concern for the protection of shareholders’ interests, especially those of minority shareholders.⁶⁷

B. Corporate Groups

If a company intends to appoint only grey outside directors, which it can do under the statutory auditor system, another reason must exist for adopting the committee system. An alternative rationale for adopting the committee system put forward by Gilson and Milhaupt is to use the committee system as a means of organizing corporate groups, in other

⁶¹ Egashira, *supra* note 6, at 23.

⁶² Gilson & Milhaupt, *supra* note 4, at 361-62.

⁶³ See Tim Burt, *New Sony Chief Wants More Foreigners on Board*, FIN. TIMES (U.K.), Mar. 13, 2005, http://search.ft.com/ftArticle?queryText=%22new+sony+chief%22&aje=true&id=050313003303&ct=0&nlick_check=1.

⁶⁴ Gilson & Milhaupt, *supra* note 4, at 362.

⁶⁵ See Makoto Komiyama & Yukinobu Masaoka, *Corporate Governance: A New Phase for Japanese Companies* 3 (Nomura Research Institute, Working Paper No. 47, 2002).

⁶⁶ SONY GLOBAL, CORPORATE GOVERNANCE SYSTEM (2006), <http://www.sony.net/SonyInfo/IR/NYSEGovernance.html> (last visited Oct. 28, 2006).

⁶⁷ Commercial Code reforms between 1993 and 2001: (a) reduced the fixing fee for shareholder derivative suits, (b) reduced the shareholding threshold to demand inspection of records, (c) mandated a board of statutory auditors for certain types of companies, and (d) expanded the authority of statutory auditors; see Milhaupt, *supra* note 3, at 5.

words, using grey outside directors to strengthen the bonds between group companies and enhance organizational flexibility.⁶⁸ Indeed, as these scholars and others point out, the Hitachi and Nomura groups cited achieving stronger group cohesion as one reason for adopting the committee system.⁶⁹ The extent to which a corporate group will benefit from adopting the committee system, however, is likely to vary depending on whether it is a vertically-aligned corporate group with a parent company and subsidiaries or a more horizontally-aligned keiretsu.⁷⁰

A vertical group can achieve stronger group cohesion by adopting the committee system because the loose definition of outside director effectively gives the parent company the power to appoint the outside directors for its subsidiaries.⁷¹ Although the major shareholder of a statutory auditor company also has the power to appoint directors, the committee system allows a parent company to gain effective control of a subsidiary board's committees by appointing as few as two outside directors.⁷² The ability to control the nomination committee, in particular, gives the parent of a company with the committee system a considerable flexibility advantage compared to the parent of a statutory auditor company. Although the maximum amount of power a parent can obtain over a subsidiary is the same both for companies with the committee system and statutory auditor companies, effective control is easier to achieve under the committee system.⁷³ Of course, the outside directors appointed for this purpose are grey outside directors so there is a risk that the goal of stronger group cohesion could instead result in stakeholder tunnelling. Indeed, it could be argued that appointing outside directors for the purpose of achieving stronger group cohesion *is* stakeholder tunnelling.

⁶⁸ *Id.* at 364-65.

⁶⁹ *Id.*; see also Hiroyuki Yanai, *The Systematization of Ethical Virtue: The Position of Japan's "Companies with Committees" System*, RESEARCH INSTITUTE OF ECONOMY, TRADE AND INDUSTRY (2003), http://www.rieti.go.jp/cgj/en/columns/columns_009.htm (last visited Oct. 15, 2006).

⁷⁰ Some argue that keiretsu never existed. See, e.g., Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 *LAW & SOC. INQUIRY* 401 (2002). Whether keiretsu exist is beyond the scope of this paper. This paper assumes that, at the very least, horizontally-aligned corporate groups resembling keiretsu do exist.

⁷¹ See Fujita, *supra* note 44, at 339-40.

⁷² See text accompanying note 31.

⁷³ This is also an advantage for companies with strategic minority shareholdings in other companies, especially if they do not have sufficient influence to control all, or even a majority of, appointments.

It would be more difficult for a keiretsu to achieve stronger group cohesion under the committee system unless there is a single controlling company, or small clique of controlling companies, that has significant control over the other companies in the keiretsu. Without a controlling company or companies, stronger cohesion could only be achieved within a keiretsu under the committee system if the member companies were able to coordinate effective appointment of outside directors among themselves. However, if such a keiretsu were to achieve stronger cohesion in this way, it would not be a result of the committee system but of the capacity for cooperation within the group.

Thus, it is the existence of a controlling company (or companies) that makes the objective of stronger group cohesion possible. The flexibility advantage the committee system offers to corporate groups can only be exploited if there is a controlling company with the power to appoint outside directors of its choosing to subsidiary boards.

C. *Industry*

In a 1990 article on the structure of Japanese companies, Professor Masahiko Aoki argued that the substantive characteristics of Japanese production determine the structure of Japanese companies.⁷⁴ Thus, according to Aoki, the traditional Japanese corporate governance mechanisms grew up in industries characterised by slow, linear change.⁷⁵ Building upon Aoki's theory, Gilson and Milhaupt argue that a company's decision to move to the committee system may be driven by its particular circumstances. Specifically, the committee system may be suitable for companies that: (a) are engaged in industries with particular characteristics, or (b) have large foreign investment or have listed on a foreign exchange.⁷⁶

Gilson and Milhaupt identify electronics as a fast-moving industry that requires a flexible governance structure able to respond quickly to market changes.⁷⁷ They suggest that the committee system is suited to the electronics industry because outside directors, without a "lifetime investment in a company's particular infrastructure," are faster at responding to changes.⁷⁸ By definition, grey directors do not fit this description, so the validity of this argument depends upon an individual

⁷⁴ Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1 (1990).

⁷⁵ *Id.*

⁷⁶ Gilson & Milhaupt, *supra* note 4, at 362-64.

⁷⁷ *Id.* at 362-63.

⁷⁸ *Id.*

company's use of outside directors. However, other elements of the committee system might contribute to managerial flexibility. The separation of the executive from the board of directors, for example, might give executive officers the managerial freedom to respond quickly and effectively to the market.⁷⁹ Furthermore, the improved monitoring mechanisms of the committee system may also make it suitable for companies in industries, such as the finance industry, that require strict regulation. On the other hand, a company's ability to perform well in a particular industry may be unrelated to its corporate governance structure. It may simply be a result of employing highly skilled people for management positions. The factors influencing corporate performance are too varied to suggest that committee system adoption in certain industries will improve corporate performance.

Companies with large foreign investments or those that are listed on foreign exchanges, however, are likely to be valued higher under the committee system because foreign investors are more familiar with, and therefore have greater confidence in, that system.⁸⁰ This is especially so with investors from countries that employ corporate governance structures similar to the Japanese committee system, such as the United States, United Kingdom, Canada, and Australia.⁸¹ Moreover, there is no reason why similar reasoning cannot be applied to the Japanese market. A company might also be valued higher in the domestic market by adopting the committee system if Japanese investors have greater confidence in that system than the statutory auditor system. The fact that a number of high profile companies, such as Resona Bank and Shinsei Bank (formerly the Long Term Credit Bank), have adopted the committee system after a crisis suggests that this is in fact the case.⁸² However, it remains to be seen exactly to what extent the mere fact of adoption of the committee system is likely to improve a company's market valuation.

⁷⁹ See text accompanying note 31.

⁸⁰ See Gilson & Milhaupt, *supra* note 4, at 363.

⁸¹ See Puchniak, *supra* note 4, at 55; see also AUSTRALIAN STOCK EXCHANGE, PRINCIPLES OF GOOD CORPORATE GOVERNANCE AND BEST PRACTICE RECOMMENDATIONS (2003), <http://www.shareholder.com/visitors/dynamicdoc/document.cfm?documentid=364&companyid=ASX>.

⁸² See Kotaro Tsuru, *Toward Reconstruction of Banks: Can Public Bailout of Resona Bank Become Model Case? (Part 2): Rebuilding of Governance System* (2003), <http://www.rieti.go.jp/en/special/policy-update/011.html> (last visited Oct. 24, 2006); see also GILLIAN TETT, *SAVING THE SUN* (2003).

D. Executive Officers

Under the committee system, a new position of executive officer was created to separate the executive management of the company from the board of directors.⁸³ In theory, the executive officer role increases (or at least maintains) the flexibility of management despite the stricter monitoring imposed by the three committees and the outside directors. Gilson and Milhaupt do not address the executive officer system, but it warrants discussion because it is a key element distinguishing the committee system from the statutory auditor system. On paper, the increased managerial flexibility under the executive officer system and improved monitoring by the committees and outside directors is the committee system's greatest advantage over the statutory auditor system.

The requirement to establish the three committees with a majority of outside directors on each committee undoubtedly gives the committee system stronger monitoring powers than exist under the statutory auditor system. Monitoring, however, is only one part of the corporate governance equation. There is no overall corporate governance advantage to improved monitoring if it detracts from management's ability to manage efficiently and effectively. The executive officer system maintains managerial flexibility in the same way that the separation of the board of directors from the board of statutory auditors does under the statutory auditor system.⁸⁴ It allows the improved monitoring mechanisms to function effectively without hindering managerial freedom.

The effectiveness of the executive officer system might be hampered, however, by the fact that the law allows a director to concurrently serve as an executive officer.⁸⁵ This makes it possible for a company to bridge the gap between directors and officers and compromises the flexibility enhancements provided by their separation. This provision undoubtedly reflects the status quo of the corporate structure in Japan whereby the directors of a company represent various divisions of the company.⁸⁶ Its existence serves to lower the barriers for a company considering moving to the committee system because it can do so without having to drastically alter its corporate organizational structure. This undermines one of the key advantages the committee system provides. If a company maintains the separation of officers and directors it is likely to achieve both improved monitoring and managerial flexibility.

⁸³ Corporations Act, art. 402.

⁸⁴ See BAUM, *supra* note 10.

⁸⁵ Corporations Act, art. 402, para. 6.

⁸⁶ See Ahmadjian, *supra* note 21.

IV. PART III: EMPIRICAL STUDY ON THE EFFECT OF COMMITTEE ADOPTION

There is no case law relating specifically to the committee system. Even if the courts had addressed the committee system, the resulting judgments would not have answered the legal questions of how the system is actually being used and how that use is perceived. Gilson and Milhaupt used event study methodology to determine market reaction to the first round of committee system adoptions in 2003.⁸⁷ There is also considerable empirical research on the United States corporate governance structure, upon which the Japanese committee system is patterned.⁸⁸ The practical application of the committee system reform in Japan, however, has not yet been empirically researched and studied. This section addresses this by introducing empirical data collected between July 2006 and October 2006.⁸⁹

The data considered here comes from interviews conducted with professionals who deal with Japanese corporate governance issues in their occupations. More than fifty professionals were contacted, a total of twenty-four were interviewed, and twenty-one sets of responses were used in the empirical analysis.⁹⁰ The respondents represented four broad categories: lawyers, auditors, ratings analysts, and bankers and institutional investors. These professions were chosen for the empirical study because their work influences how the committee system is implemented by companies and evaluates the operational committee system. Therefore, their impressions of how the system is being used, and whether it is accomplishing the reform's stated objectives, should provide rich data regarding the functional success of the reforms in Japanese corporate monitoring and flexibility.⁹¹

⁸⁷ Gilson & Milhaupt, *supra* note 4, at 366-69.

⁸⁸ See, e.g., Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898; James Brickley, *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371 (1994); John Byrd and Kent Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195 (1992); Rita Kosnik, *Greenmail: A Study of Board Performance in Corporate Governance*, 32 ADMIN. SCI. Q. 163 (1987).

⁸⁹ The research application titled "Japanese Corporate Governance Structures" was submitted to the Australian National University Human Research and Ethics Committee on July 3, 2006. Formal approval for the project was granted by the Committee on Aug. 22, 2006.

⁹⁰ The standard interview questions are attached as an appendix to this article. Four of the respondents completed questionnaires containing the standard interview questions instead of being interviewed.

⁹¹ Readers may be curious about the language in which the interviews were conducted. Interviews with non-Japanese respondents were held entirely in English.

The interview questions were designed to generate a comprehensive understanding of the differences in the respondents' approaches to their work and the outcomes of their work, depending upon whether they are dealing with a company with the committee system or a company with a statutory auditor.⁹² The questions specifically address the four areas of inquiry set out in Part 2—outside directors, corporate groups, industry and executive officers—so that the theoretical speculations regarding the committee system can be tested against the empirical data. Respondents provided general perceptions of the committee system as well as provided additional comments.⁹³

A. *The Data Set*

1. *Lawyers*

Responses from six lawyers including in-house counsel and lawyers at private firms were included in the empirical results. The lawyers who answered the questionnaire advise companies on whether to adopt the committee system and on the effective implementation of the committee system to improve monitoring and flexibility. Thus, as a group, lawyers' impressions of the efficacy of the system are directly related to the rate of uptake by companies and the way in which the system is used by client companies.

a. *Outside directors*

The empirical and anecdotal data collected from interviews with the lawyers indicate a general perception that monitoring is not improved with the committee system because the outside directors are not truly independent. Satoshi Kawai, a corporate/mergers and acquisitions lawyer, suggests that outside directors from related corporations are not outside directors despite the legal definition of the term, and that there is no meaningful difference between companies with the committee system and statutory auditor companies.⁹⁴ This dim view of grey directors is shared

Interviews with Japanese respondents usually involved some English and some Japanese, depending on the relative linguistic strengths of the author and the respondent. In some cases interviews with Japanese respondents were almost entirely in English and in other cases they were almost entirely in Japanese. The majority were somewhere in between.

⁹² Thanks to Dr. Mark Nolan for advising on the design of the standard interview questions.

⁹³ The responses do not necessarily reflect the views of the organizations with which the respondents are affiliated, even if the organizations are included in the citations of the interviews or questionnaires.

⁹⁴ Telephone Interview with Satoshi Kawai, Partner, Mori Hamada & Matsumoto (Aug. 16, 2006).

by other respondents in this category.⁹⁵ This view implies that monitoring is strengthened where the outside directors in a company with the committee system are truly independent. Takashi Miyazaki, a private lawyer, points out the reality is that truly independent outside directors are difficult to find in Japan.⁹⁶

b. Corporate groups

The data on lawyers indicates that corporate group issues are intertwined with outside director issues. Kawai suggests it is meaningless for subsidiaries under a parent company to adopt the committee system because the outside director positions would simply be filled by people from within the vertical group.⁹⁷ None of the lawyer respondents suggested that this would be a positive development. There may, however, be some benefit in the parent company adopting the committee system because the legal definition of outside director precludes the appointment of representatives from its subsidiaries.⁹⁸ It is therefore more likely that the outside directors of the holding companies would be genuinely independent. The same limitation does not apply to keiretsu, which are horizontally aligned.

c. Industry

Two of the lawyer respondents suggested that companies that are listed on a foreign exchange or that have a substantial number of shares held by international investors are likely to receive a valuation benefit from adopting the committee system.⁹⁹ This is especially relevant to United States and United Kingdom investors who are likely to have greater confidence in the committee system because it is based upon the corporate governance structures of those countries.

The lawyer respondents suggested that companies in industries requiring managerial flexibility and speedy decision-making, such as electronics, would see improved performance under the committee system.¹⁰⁰ This belief is based upon the technical separation of officers and directors in the committee system structure and a trend among

⁹⁵ Telephone Interview with Takashi Miyazaki, Lawyer, Nagashima Ohno & Tsunematsu (Aug. 11, 2006).

⁹⁶ *Id.*

⁹⁷ Interview with Kawai, *supra* note 94.

⁹⁸ *Id.*

⁹⁹ Interview with Miyazaki, *supra* note 95; Telephone Interview with Akihisa Shiozaki, Lawyer, Nagashima Ohno & Tsunematsu (Sept. 12, 2006).

¹⁰⁰ Interview with Miyazaki, *supra* note 95.

companies with the committee system to have significantly fewer directors than statutory auditor companies of similar size. Respondents also pointed out that some companies with the committee system perform badly while statutory auditor companies in similar industries perform well.¹⁰¹ Kawai suggests that flexibility and speedy response are dependent upon the ability of management.¹⁰² Miyazaki reinforces this view: “Sony probably could have made speedy decisions even under the statutory auditor system.”¹⁰³ Miyazaki also suggested that companies in the finance industry might be valued higher under the committee system due to the need for stricter monitoring in that industry.¹⁰⁴

d. Executive officers

The lawyer data suggests generally mixed views on the significance of executive officer positions. Some responses indicate that it may be an advantage, especially in large companies, to have a CEO who can make decisions without referring to a large board of directors.¹⁰⁵ Other responses suggest that the representative director position in statutory auditor companies possesses similar powers and there is little difference between the two.¹⁰⁶ Overall, the lawyer respondents did not believe this was a determinative factor in enhancing corporate flexibility.

e. General perceptions

Kaname Minakawa, an in-house corporate governance expert, believes that the committee system is not institutionally better or worse than the statutory auditor system. More important, states Minakawa, is the priority given to operational corporate governance under either system.¹⁰⁷ Other respondents viewed the committee system reform as a neutral development with both positive and negative aspects.

2. Auditors

Responses from a total of five auditors were included in the empirical results. This number includes external auditors working at accounting firms, such as PricewaterhouseCoopers, and internal auditors

¹⁰¹ *Id.*

¹⁰² Interview with Kawai, *supra* note 94.

¹⁰³ Interview with Miyazaki, *supra* note 95.

¹⁰⁴ *Id.*; Interview with Kawai, *supra* note 94.

¹⁰⁵ Interview with Shiozaki, *supra* note 99.

¹⁰⁶ Interview with Miyazaki, *supra* note 95.

¹⁰⁷ Questionnaire from Minakawa Kaname, organization and position undisclosed, (Oct. 23, 2006).

working in Japanese corporations. Auditors assess the effectiveness of a company's internal governance and control systems, and make recommendations for improvement. Thus, as with lawyers, their views can influence whether, and how, the committee system is implemented by their client companies. In other words, auditors' impressions of the efficacy of the system directly impact the decisions of companies as well as the form of adoptions, such as whether grey or truly independent outside directors are appointed.

a. Outside directors

The data indicates that auditors do see value in having outside directors on the board of a company. Hideki Akita, a certified public accountant at Misuzu Audit Corporation, stated that due to the existence of outside directors in companies with the committee system the "internal checks are much stronger, and there is a feeling of safety."¹⁰⁸ However, as with the lawyers, the majority of auditor respondents suggested that there was little value in having grey outside directors because this weakens the monitoring function of the committee system.¹⁰⁹ Some auditor respondents stated that they would be "more cautious" when auditing companies with grey outside directors.¹¹⁰

b. Corporate groups

The data indicates that auditors, like lawyers, believe the parent company plays an important role in assessing the effect of the committee system in a corporate group. Responses suggest that if the parent company adopted the committee system then internal checks within the corporate group are strengthened.¹¹¹ The same effect would not be achieved if only subsidiary companies adopted the committee system. Internal checks would also be strengthened if both the parent company and its subsidiaries adopted the committee system, but there was concern that the positions of outside directors within the subsidiaries would be filled by representatives from the parent company or elsewhere in the group.¹¹²

¹⁰⁸ Telephone Interview with Hideki Akita, Audit Manager, Misuzu Audit Corp. (Oct. 6, 2006).

¹⁰⁹ *Id.*; see also Telephone Interview with Takashi Okabayashi, Supervisor, Misuzu Audit Corp. (Oct. 6, 2006).

¹¹⁰ Interview with Okabayashi, *supra* note 109.

¹¹¹ *Id.*

¹¹² *Id.*

c. Industry

The data indicates consensus among auditors that a company's industry makes little difference to the effect of committee system adoption. As with lawyers, however, some auditors suggested that companies listed on foreign exchanges or that otherwise seek foreign investment may be valued higher by the market under the committee system because investors from the United States and United Kingdom especially are familiar with and have greater confidence in that system.¹¹³

d. Executive officers

The data indicates that auditors believe there is little practical difference between a managing director in a statutory auditor company and a CEO in a company with the committee system, despite the technical separation of directors and executive officers under the committee system.¹¹⁴ This impression is based on the fact that the committee system does not prevent directors from concurrently serving as officers. Nevertheless, responses indicate that a company may receive a valuation benefit from the positive image created by the illusory separation.¹¹⁵

e. General perceptions

The auditor responses indicate that there are both positive and negative aspects to committee system adoption. Internal control systems are generally more effective under the committee system.¹¹⁶ Committee system adoption also fosters a positive public image because it is considered to be more transparent.¹¹⁷

3. *Bankers and institutional investors*

Responses from a total of six bankers and institutional investors were included in the empirical results. This number includes representatives from commercial banks, investment banks such as Nomura Securities, and investment fund managers such as Barclays Global. The work of the respondents in this category includes assessing a company's suitability for loans and investment, advising on investment strategies and representing shareholder interests. The bankers' and institutional

¹¹³ Telephone Interview with Yasushi Tsutsumi, Supervisor, Misuzu Audit Corp. (Oct. 6, 2006).

¹¹⁴ *Id.*; Interview with Akita, *supra* note 108.

¹¹⁵ Telephone Interview with Hideaki Kurosaki, Senior Staff, Misuzu Audit Corp. (Oct. 6, 2006).

¹¹⁶ Interview with Akita, *supra* note 108.

¹¹⁷ Interview with Tsutsumi, *supra* note 113.

investors' impressions therefore influence whether a company implements the committee system. Further, because financing is dependent upon their impressions they will also indirectly affect the market valuation of a company.

a. Outside directors

The data indicates that bankers and institutional investors strongly favor companies with outside directors. Some respondents stated that they prefer client companies and companies in which they invest to have a majority of outside directors, despite the legal minimum of just two outside directors for companies with the committee system.¹¹⁸ There were, however, mixed views on the level of independence of outside directors. One respondent had a negative view of grey outside directors and did not consider them to be independent at all.¹¹⁹ The majority believed, however, that the value of a grey outside director was dependent upon the company.¹²⁰ It is positive if the company makes an effort to create a meaningful role for the outside director.¹²¹ The data from bankers and institutional investors also suggests that grey outside directors, especially those from parent companies, may be valuable because they are likely to have in-depth knowledge of the company as well as the influence to make action happen.¹²² Respondents warned, however, that the ability to make action happen is highly variable because the resulting action will not necessarily be in the interests of stricter monitoring.¹²³

b. Corporate groups

The data from bankers and institutional investors indicates a common belief among these professionals that a company's inclusion in a vertical group or keiretsu is of little importance to the committee system. Respondents indicated that inclusion may have an impact on a company's corporate governance, especially if the company is a one hundred percent subsidiary, but such impact would be unrelated to whether the company

¹¹⁸ Telephone Interview with Anonymous Respondent, organization and position undisclosed, (Sept. 12, 2006).

¹¹⁹ *Id.*

¹²⁰ Telephone Interview with Nicholas Benes, Managing Director, JTP Corp. (Sept. 4, 2006); Telephone Interview with Sadakazu Osaki, Nomura Inst. of Capital Markets. Research (Sept. 5, 2006); Telephone Interview with Nami Matsuko, Investment Banker, Nomura Sec. (Oct. 5, 2006).

¹²¹ Interview with Benes, *supra* note 120.

¹²² *Id.*; Interview with Osaki, *supra* note 120.

¹²³ Interview with Benes, *supra* note 120.

has adopted the committee system.¹²⁴ Moreover, the data suggests that the value of outside directors is heavily dependent upon the attitude of the vertical group or keiretsu to corporate governance.

c. Industry

The data indicates that a number of bankers and institutional investors believe that committee system adoption has no bearing on a company's performance in a particular industry.¹²⁵ Nevertheless, one respondent remarked that while committee system adoption is probably not more or less suited to any specific industries, he believed that an outside director would be less effective in that role if the company operated in an industry with which outside directors were unfamiliar.¹²⁶

d. Executive officers

The data from bankers and institutional investors indicates a near unanimous belief that the existence of a CEO has no impact on the effect of committee system adoption.¹²⁷ One respondent stated very succinctly that "it is irrelevant to how investors exert influence on the company."¹²⁸

e. General perceptions

The banker and institutional investor respondents focused heavily on the issue of outside directors. There was little concern for other factors unless they impacted the function of outside directors. The majority of respondents believed that the mere fact that a company has adopted the committee system is unlikely to have a positive effect on the performance of that company. The real issue is how a company that has adopted the committee system then utilizes that system. For the respondents in this category this issue essentially concerns the approach a company takes to the function of outside directors.

¹²⁴ Interview with Osaki, *supra* note 120.

¹²⁵ *Id.*; Telephone Interview with Anonymous Respondent, organization and position undisclosed, (Sept. 12, 2006).

¹²⁶ Questionnaire from Tatsuro Goshima, organization and position undisclosed, (Sept. 25, 2006).

¹²⁷ Telephone Interview with Anonymous Respondent, organization and position undisclosed, (Sept. 12, 2006); Interview with Benes, *supra* note 120; Interview with Matsuko, *supra* note 120; Interview with Osaki, *supra* note 120.

¹²⁸ Telephone Interview with Anonymous Respondent, organization and position undisclosed, (Sept. 12, 2006).

4. Ratings analysts

Responses from a total of four ratings analysts were included in the empirical results. All respondents were from private ratings firms, namely Fitch and Standard & Poor's. Ratings analysts evaluate the implementation of the committee system by different companies as part of a company's credit rating assessment. Their views are therefore highly important in relation to the market valuation and share price of a company with the committee system. In other words, if ratings analysts have a favorable impression of the committee system in improving monitoring and flexibility of the company from a statutory auditor system, this will translate into a higher rating and, in turn, a higher valuation for the company. In short, ratings analysts' impressions are crucial to the market valuation of the benefit of the reform.

a. Outside directors

The data indicates that ratings analysts, like lawyers and unlike bankers and institutional investors, are skeptical of outside directors in the committee system. Pekka Laitinen of Fitch Japan views committee system adoption negatively if it is clear that the outside directors are merely a façade and the monitoring mechanisms are not working.¹²⁹ Naoko Nemoto of Standard & Poors Japan stated that she also prefers genuinely independent outside directors when rating a company with the committee system.¹³⁰ However, responses suggest that ratings analysts are more willing than lawyers to give grey outside directors some leeway. According to Tatsuya Mizuno, also of Fitch Japan, it is not important whether or not an outside director is independent on paper. He is more concerned with the extent to which the company values strong corporate governance and the level of vigilance outside directors exhibit.¹³¹

b. Corporate groups

Responses suggest that the affiliation of a company with the committee system with a vertical group or keiretsu is of little concern to ratings analysts. There were differing reasons for this view. At least one respondent, Laitinen, expressed the view that keiretsu are gradually weakening.¹³² In contrast, Nemoto suggested that most Japanese

¹²⁹ Telephone Interview with Pekka Laitinen, Senior Director, Fitch Japan (Aug. 11, 2006).

¹³⁰ Telephone Interview with Naoko Nemoto, S&P Japan (Aug. 9, 2006).

¹³¹ Telephone Interview with Tatsuya Mizuno, Corporate Director, Fitch Japan (Aug. 16, 2006).

¹³² Interview with Laitinen, *supra* note 129.

companies are affiliated with other companies in some way even if they are not technically part of a corporate group.¹³³ There was consensus that it is better to assess the governance of companies individually, especially since attitudes toward corporate governance can vary among companies within a corporate group.¹³⁴

c. Industry

The responses indicate that the industry to which a company with the committee system belongs is not a significant consideration for ratings analysts.¹³⁵ As with the lawyers, some respondents expressed the view that the committee system may be suited to industries that require strict monitoring or quick responses from management.¹³⁶ Moreover, Mizuno suggested that the committee system gives an impression of strong corporate governance, which may be an advantage in industries where consumer reaction to management is important.¹³⁷ Unlike the lawyers, however, none of the ratings analysts specifically stated that the committee system might be suitable for companies with large foreign investment.

d. Executive officers

The data indicates that the title of executive officer is of little consequence to ratings analysts. Whether a CEO is viewed as actually having an effect on a company's governance is of greater importance. Nemoto believes that a CEO under the committee system makes little difference because the decision making and monitoring functions still overlap.¹³⁸ This is a weakness in Japanese corporate governance and an area that is still developing for both companies with the committee system and statutory auditor companies.¹³⁹ Only Laitinen is inclined to view the CEO as a positive factor. He concedes, however, that it is only a minor consideration and not, on its own, determinative in the ratings process.¹⁴⁰

¹³³ Interview with Nemoto, *supra* note 130.

¹³⁴ On this point, Tatsuya Mizuno used the example of the Mitsubishi group, whose member companies have varying approaches to corporate governance. Interview with Mizuno, *supra* note 131.

¹³⁵ Interview with Nemoto, *supra* note 130; Interview with Laitinen, *supra* note 129.

¹³⁶ Interview with Laitinen, *supra* note 129.

¹³⁷ Interview with Mizuno, *supra* note 131.

¹³⁸ Interview with Nemoto, *supra* note 130.

¹³⁹ *Id.*

¹⁴⁰ Interview with Laitinen, *supra* note 129.

e. General perceptions

A majority of ratings analysts expressed a qualified opinion that the committee system reform was more positive than negative. Ultimately, however, a company's rating is dependent upon many factors, and committee system adoption by itself is not determinative. Nevertheless, Laitinen believes the committee system reform may have triggered improvements in Japanese corporate governance, especially transparency in corporate governance, and that these improvements are not limited to companies with the committee system.¹⁴¹ Finally, Mizuno suggests that the committee system is perceived by the public to be a stronger corporate governance model. As a result, companies in crisis tend to adopt the committee system for the cosmetic effect of reassuring the market.¹⁴²

V. PART III: ANALYSIS OF THE EMPIRICAL DATA

In this section I analyze the impressions of the committee system collected from lawyers, auditors, bankers and institutional investors, and ratings analysts. I use this data to test the accuracy of the theoretical speculations in Part 2 and reach conclusions as to how the committee system is actually being used. Specifically, I address whether committee system adoption results in improvements to monitoring mechanisms or managerial flexibility, or leads to a higher market valuation. Finally, based on these conclusions, I briefly discuss areas for reform of the law and improvements to committee system implementation.

In this section I analyze the empirical results as a whole because decisions about adoption and implementation of the committee system will be influenced by the impressions of more than one of the respondent categories. As an example, although the impressions of lawyers and auditors will have a direct impact upon the rate of uptake, the impressions of bankers and institutional investors, and ratings analysts, can also indirectly impact uptake if managers believe that their company will be valued higher under the committee system. Nevertheless, the data from a particular respondent category or categories is emphasised where it is of specific relevance in the analysis.

A. *Outside Directors*

There is evidence in the empirical results to support Gilson and Milhaupt's argument that the loose definition of outside director does not ensure outside directors are divorced from the interests of either

¹⁴¹ *Id.*

¹⁴² Interview with Mizuno, *supra* note 131.

controlling shareholders or other stakeholders. Respondents from all categories value truly independent outside directors over grey outside directors.¹⁴³ It was even suggested that grey outside directors are not outside directors.¹⁴⁴ The impressions of auditors in this regard are particularly relevant because a key element of their job is to ensure effective internal monitoring. The impressions of ratings analysts and bankers and institutional investors are also significant because they indicate a belief that the presence of outside directors increases shareholder value.

The empirical data indicates that most respondents are concerned that outside director positions are not used to improve monitoring. This suggests that companies with the committee system do appoint grey outside directors, even though this would not provide a monitoring advantage over the statutory auditor system, and, therefore, that there are reasons for adopting the committee system other than having independent outside directors. One possibility is better organization of corporate groups. Another possibility, as some respondents suggest, is gaining a market valuation advantage from giving the illusion of stronger governance.

There is empirical evidence, however, to support Puchniak's argument that grey outside directors can strengthen a company's governance. At least two respondents suggested that grey outside directors often have a constructive understanding of the company's business and the seniority to exert influence and make action happen.¹⁴⁵ This might translate into a capacity to monitor management more effectively. However, the ability to make action happen can be both positive and negative depending upon the interests a grey outside director serves.¹⁴⁶ Whether or not a grey outside director strengthens a company's governance is therefore dependent upon the circumstances of the individual company. The same could be said even of truly independent outside directors.

As a result, narrowing the legal definition of outside director to exclude grey outside directors is not only unlikely to help defeat stakeholder tunnelling but may actually eliminate opportunities to strengthen corporate governance. Instead, efforts might be made to

¹⁴³ Interview with Kawai, *supra* note 94; Interview with Akita, *supra* note 108; Telephone Interview with Anonymous Respondent, organization and position undisclosed, (Sept. 12, 2006); Interview with Nemoto, *supra* note 130.

¹⁴⁴ Interview with Kawai, *supra* note 94.

¹⁴⁵ Interview with Benes, *supra* note 120; Interview with Osaki, *supra* note 120.

¹⁴⁶ Interview with Benes, *supra* note 120.

encourage, rather than force, companies to appoint truly independent outside directors. Further, companies might be encouraged to take corporate governance issues seriously and create corporate environments in which grey directors will enhance, rather than compromise, monitoring. To achieve these goals reference can be made to the U.S., U.K., Canadian and Australian experiences where the recommendations of major pension funds, corporate governance organizations, and stock exchanges have brought about large contingents of independent directors on corporate boards.¹⁴⁷ Interestingly, some respondents suggested that the committee system reform itself is serving to increase awareness of corporate governance.¹⁴⁸

Regardless of the nature of the director, it is worth putting in place measures to prevent outright abuse of the system. Rather than narrowing the legal definition of outside director, this would be better achieved through criminal and civil penalties on particular activities. Even truly independent outside directors (and others) may engage in activities intended to be prevented. Imposing penalties instead of narrowing the definition would not reduce the number of eligible outside directors, and this is especially relevant in Japan where the pool of candidates is already shallow.¹⁴⁹

Finally, evidence suggesting that outside directors can improve monitoring and contribute to defeating stakeholder tunnelling undermines Gilson and Milhaupt's argument that stakeholder tunnelling is a cultural characteristic of Japan. All categories indicated a preference for truly independent outside directors.¹⁵⁰ This suggests a belief that truly independent outside directors do strengthen monitoring, which contradicts the Gilson and Milhaupt argument. Although this evidence does not eliminate the possibility of stakeholder tunnelling being culturally embedded in Japan, it at least suggests it is not a major concern to those responsible for implementing, regulating and evaluating the committee system.

¹⁴⁷ See, e.g., CALIFORNIA PUB. EMPLOYEES' RETIREMENT SYS., CORPORATE GOVERNANCE CORE PRINCIPLES AND GUIDELINES (2006), <http://www.calpers-governance.org/principles/domestic/us/page01.asp> (last visited Oct. 28, 2006); AUSTRALIAN STOCK EXCHANGE, *supra* note 81.

¹⁴⁸ Interview with Laitinen, *supra* note 129.

¹⁴⁹ Interview with Miyazaki, *supra* note 95.

¹⁵⁰ Interview with Kawai, *supra* note 94; Interview with Akita, *supra* note 108; Telephone Interview with Anonymous Respondent (name, organization and position title undisclosed at respondent's request) (Sept. 12, 2006); Interview with Nemoto, *supra* note 130.

B. Corporate Groups

The auditor and lawyer results¹⁵¹ indicate that vertical groups have an advantage over keiretsu under the committee system.¹⁵² However, it is not a flexibility advantage resulting from the parent company's ability to appoint outside directors to subsidiaries. On the contrary, it is because, by definition, a company's outside directors cannot be associated with one of its subsidiaries. Thus, there is a greater likelihood that the outside directors of a parent company will be genuinely independent because its pool of grey outside director candidates is reduced.¹⁵³ A keiretsu, on the other hand, is characterized by horizontal cross-shareholdings rather than parent-subsidiary relationships. As a result, the pool of outside director candidates from within the group is virtually unlimited.¹⁵⁴ Furthermore, the auditor results indicate that where there is a controlling company in a group there is likely to be more thorough internal regulation throughout the group. This suggests that the existence of a controlling company does improve corporate governance, at least from a monitoring perspective.

However, the positive aspects of a vertical group with a controlling company do not appear to extend to the ability to enhance group cohesion under the committee system. Theoretically, the parent of a committee system company has a flexibility advantage compared to the parent of a statutory auditor company because it can attain effective control of the subsidiary via its committees—especially the nomination committee—by appointing as few as two outside directors. The parent of a statutory auditor company, in comparison, would need to appoint a majority of the subsidiary's directors to achieve a similar level of control. The empirical data suggests, however, that any flexibility advantage a parent company may obtain from the ability to control a subsidiary's nomination committee is largely ignored because the outside directors are not independent.¹⁵⁵ In other words, the respondents discount the value of outside directors from within a corporate group because they are grey outside directors *before* they can assess how the grey directors can enhance the flexibility of group management.

¹⁵¹ The impressions of lawyers and auditors are of significance to the discussion regarding corporate groups because they largely relate to methods of implementing the committee system.

¹⁵² Interview with Kawai, *supra* note 94; Interview with Akita, *supra* note 108.

¹⁵³ Interview with Kawai, *supra* note 94.

¹⁵⁴ Of course, this would only be the case in a completely horizontal keiretsu.

¹⁵⁵ Interview with Kawai, *supra* note 94; Interview with Akita, *supra* note 108; Interview with Okabayashi, *supra* note 109.

Overall, the empirical data suggests there is no flexibility advantage in a corporate group adopting the committee system. Contrary to Gilson and Milhaupt's argument, any flexibility gained from the enhanced group cohesion is undermined by a perceived reduction in monitoring effectiveness caused by the appointment of grey directors. This is a zero-sum equation. There is no way to accommodate both objectives without also compromising both.

Interestingly, the data indicates greater concern for the monitoring side of this equation. Maintaining monitoring standards in corporate governance is certainly important, but the empirical data suggests a lack of appreciation for the group cohesion benefits available to a vertical group under the committee system. The corporate group scenario is an example of how grey outside directors can play an important flexibility role, in addition to a monitoring role. The recommendations of influential institutions, among other methods, might also be used to raise awareness of this additional function of grey outside directors.

C. *Industry*

The empirical data supports the view that committee system adoption does not heavily influence corporate performance in a particular industry. A few respondents suggested that companies in industries requiring swift managerial response, such as the electronics industry, or strict monitoring, such as the finance industry, might attain those capabilities under the committee system.¹⁵⁶ The consensus in all respondent categories, however, was that the committee system will not necessarily give a company the attributes required to perform well in an industry. Considering that market valuation is a key indicator of corporate performance, it is significant that many ratings analysts, bankers and institutional investors held this view.¹⁵⁷ An oft-stated reason for this view is that some companies with the committee system are performing badly while statutory auditor companies in similar industries are performing well, and vice versa.¹⁵⁸ This suggests that other factors, such as the quality of management, play at least as important a role in a company's performance in a particular industry as adoption of the committee system.

¹⁵⁶ Interview with Miyazaki, *supra* note 95; Interview with Laitinen, *supra* note 129.

¹⁵⁷ Interview with Nemoto, *supra* note 130; Interview with Laitinen, *supra* note 129; Interview with Osaki, *supra* note 120; Telephone Interview with Anonymous Respondent (name, organization and position title undisclosed at respondent's request) (Sept. 12, 2006).

¹⁵⁸ Interview with Miyazaki, *supra* note 95.

The lawyer and auditor respondents indicated that companies in industries with large levels of foreign investment, or that have listed on a foreign exchange, would be valued higher for adopting the committee system.¹⁵⁹ The familiarity with the committee system of the U.S. and U.K. markets, in particular, increases their confidence in companies with the committee system and consequently how much they will pay for those companies. The fact that lawyers and auditors have this impression may be one reason why the uptake of the committee system has been high among companies with foreign investment.¹⁶⁰ Moreover, the fact that ratings analysts, bankers and institutional investors do not have this impression explains why, according to Gilson and Milhaupt's market reaction study, those companies' market valuations have not changed significantly.¹⁶¹ Interestingly, one ratings analyst, in addition to some auditor respondents, indicated that there was a public perception in Japan of the committee system as a stronger and more transparent corporate governance structure.¹⁶² This impression, however, is not supported by Gilson and Milhaupt's market event study. Thus, even if the committee system is perceived, both in Japan and overseas, to be better than the statutory auditor system, it is unclear whether that will result in higher market valuation.

D. *Executive Officers*

The empirical data indicates that executive officers provide little flexibility enhancement to a company's governance. Only a few of the lawyers—and none of the respondents from the other categories—suggested that a company with the committee system would achieve greater managerial flexibility from the separation of officers from directors.¹⁶³ However, the data also suggests there is a lack of appreciation in the market of the value of this separation. This is exhibited in two forms. First, at the very least there is a lack of understanding of the function the separation is intended to serve. This is indicated in the results from bankers and institutional investors where there was a near unanimous

¹⁵⁹ *Id.*; Interview with Tsutsumi, *supra* note 113.

¹⁶⁰ See JAPAN CORPORATE AUDITORS ASS'N, *supra* note 33.

¹⁶¹ Gilson & Milhaupt, *supra* note 4, at 366-69.

¹⁶² Interview with Mizuno, *supra* note 131; Interview with Tsutsumi, *supra* note 113.

¹⁶³ Interview with Shiozaki, *supra* note 99.

belief that the existence of a CEO has no impact on the performance of a company with the committee system.¹⁶⁴

Furthermore, some of the lawyer responses suggest that executive officers have similar powers to directors in statutory auditor system companies and there is little difference between the two.¹⁶⁵ Second, in practice the separation of directors and officers in the committee system is not maintained. This is a key reason given by a number of respondents for why they place little value on executive officers in the committee system.¹⁶⁶ The main cause appears to be that directors can concurrently serve as executive officers under the Corporations Act. An obvious solution to this problem would be to abolish the provision allowing directors to concurrently serve as officers. Some companies, however, may move to the committee system only for the cosmetic effect, while essentially retaining a corporate governance model similar to the statutory auditor system. Far from persuading these companies to put in place strict separation of directors and officers, the abolition of that provision may simply cause them to not adopt the committee system.

A more effective method would be to encourage those companies to enforce the separation of directors and officers voluntarily. Again, the recommendations of influential institutions might achieve this objective. Ironically, the goal might also be achieved, albeit indirectly, by encouraging committee system companies to appoint truly independent outside directors in greater numbers. The independence of the outside directors would enhance the company's monitoring mechanisms and that, without effective separation of directors and officers, would eventually impede managerial flexibility. This, in turn, would give a company an incentive to separate directors and officers of its own accord.

VI. CONCLUSION

In 2002, a number of high-profile Japanese companies moved to the new committee system corporate governance structure, despite scandals surrounding the U.S. system upon which it was modeled. Shortly thereafter, Ronald Gilson and Curtis Milhaupt speculated on the strategies of those companies that moved to the new system. This paper sought to test those strategies, and the overall effect of the operational committee system law reform, by assessing four aspects of the committee system that distinguish it from the statutory auditor system: outside directors,

¹⁶⁴ Telephone Interview with Anonymous Respondent, organization and position undisclosed, (Sept. 12, 2006); Interview with Benes, *supra* note 120; Interview with Matsuko, *supra* note 120; Interview with Osaki, *supra* note 120.

¹⁶⁵ Interview with Miyazaki, *supra* note 95.

¹⁶⁶ Interview with Nemoto, *supra* note 130.

corporate groups, industry and executive officers. It did this by collecting and analyzing empirical data on the impressions of those indirectly charged with implementing and evaluating the committee system reform: lawyers, auditors, bankers and institutional investors, and ratings analysts.

The results indicate that the operational committee system provides few advantages over the statutory auditor system. There is considerable scepticism of the monitoring ability of outside directors due to the loose definition of that term. Moreover, despite the monitoring and flexibility benefits grey outside directors can bring to a company with the committee system, their value is unappreciated because they are not truly independent. This is most evident in relation to corporate groups, where efforts to strengthen group cohesion are undermined by the necessary use of grey outside directors. Further, the separation of executive officers from the board of directors does not enhance flexibility because the law allows directors to concurrently serve as officers. There is also no strong evidence that the committee system provides companies with the capabilities to perform well in specific industries, or that the committee system's positive image contributes to higher market valuation.

The solution, however, is not further reform of the committee system law. Narrowing the definition of outside director, for example, would simply prevent companies from deriving both monitoring and flexibility benefits from grey outside directors without necessarily improving the monitoring mechanism of the committee system. Similarly, changing the law to prevent directors of companies with the committee system from concurrently serving as executive officers is only likely to reduce the committee system's attractiveness. On the other hand, the committee system's monitoring mechanisms might be improved by encouraging companies with the committee system to appoint truly independent outside directors in greater numbers, and to create environments in which grey outside directors will monitor effectively. The adverse effect this strengthened monitoring would have on managerial freedom might also indirectly encourage companies with the committee system to separate executive officers from directors more strictly.

The committee system is not a panacea for all corporate governance and corporate performance woes. That much is evident from the many poor-performing companies that have adopted the committee system. The committee system does, however, resemble a placebo. It is perceived to be a stronger and more transparent corporate governance system, even though the empirical data suggests that in practice it is generally neither stronger nor more transparent than the statutory auditor system.

The legal structure of the committee system nevertheless offers advantages over the statutory auditor system. It offers stronger monitoring

mechanisms in the form of mandatory committees and outside directors, and it separates officers and directors to ensure those monitoring mechanisms do not impede managerial flexibility. It also offers a means of enhancing the organizational flexibility of corporate groups. These monitoring and flexibility advantages, however, are presently misunderstood and misapplied. Implementing the committee system in a way that capitalizes on these advantages may bring an increase in market valuation that mere adoption will not.

APPENDIX: STANDARD INTERVIEW QUESTIONS

1. How do you describe your job?
2. In what contexts do you deal with corporate governance issues in your work?
3. How regularly do you deal with corporate governance issues in your work?
4. How long have you been doing this work?
5. Is there a difference in the way you approach your work, or in the outcome of your work, when dealing with corporations that have adopted the committee system compared to corporations that have retained the statutory auditor system? Please explain the reason for the difference.
6. If one or more of the outside directors in a company with the committee system is an employee of the parent company or a related body corporate, or otherwise affiliated with the company, does that affect the outcome and/or approach of the work you do? Please explain.
7. Compared to a statutory auditor system corporation, does the fact that a company with the committee system has executive officers, and in particular a chief executive officer, affect the outcome and/or approach of the work you do? Please explain.
8. Is there a difference in the outcome and/or approach of the work you do in relation to a company with the committee system that is part of a corporate group or keiretsu compared to a stand-alone company that has adopted the committee system? Please explain.

9. Does the outcome and/or approach of the work you do in relation to a committee system corporation differ depending on the industry within which that corporation operates? Please explain.

10. In your professional opinion, the adoption of the committee system generally has (please choose one option):
 - a. a positive effect on the performance of a corporation;
 - b. a negative effect on the performance of a corporation; or
neither a positive nor negative effect on the performance of a corporation