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See, hear, speak no evil is the norm in Japan's boardrooms

JapanBusinessSeminar
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Anyone thinking of investing in Japanese stocks is sure to be given pause by the nation's long list of boardroom scandals, including those at Livedoor Co., Olympus Corp., Daio Paper Corp. and AIJ Investment Advisors Co. Authorities' slow and selective responses to address the underlying issues presented by each new scandal only reinforce the belief that Japanese corporate governance is not ship-shape. What's gone wrong at the top?

Company boards in Japan are mostly dominated by insiders. That is a historical legacy of Japan's postwar Occupation, which replaced prewar capitalists with internal board managers. Here, during the postwar period, corporate governance has been concerned with a wider group of stakeholders, beyond shareholders in the traditional sense. Employees, for example, until recently held the expectation of lifetime employment.

An unintended consequence is that directors, having spent a lifetime working their way to the top of the corporate hierarchy, have nowhere to go should shareholders decide to remove them.

In Japan, outsiders are not welcome to peer into the boardroom. This is even reflected in the company law. Unlike in the U.S., where an outsider can be appointed CEO, the representative director (CEO) of a Japanese statutory audit committee-style company (the most common form of listed firm) can only be appointed from among sitting directors. That means the directors cannot easily consider anybody else for the top position, even if they are very capable.

What's more, the incumbent CEO often promoted the other directors into their present roles, so they are likely loyal to the CEO. Should there be any boardroom improprieties, as happened in the four cases mentioned earlier, there are fewer mechanisms in Japan to ensure that directors are not in cahoots with the CEO.

How does corporate governance work elsewhere? Under U.S. Delaware law, there are strong incentives for companies to form and delegate decisions to a committee of independent, outside directors when managerial conflicts or self-interest could significantly affect shareholder value.

When approving management buyouts or defending hostile takeovers, for example, the bar for managerial due care is set at a higher level unless such committees are used. In a shareholder lawsuit, the burden of proof regarding wrongdoing shifts to the defendant directors in those instances, unless the decision was made by a committee of independent directors.

On the other hand, if such a committee is used, the bar is kept at its usual lower level, with the burden of proof resting squarely on the plaintiffs.

Under Japanese corporate law, however, there is only a single bar for due care, and it is set at the lower level. Nor are companies allowed to form or delegate decisions to legally valid committees. And no rule or law encourages the appointment of independent directors. Here, a board of three statutory auditors (*kansayaku*) is charged with conducting accounting and legal audits. The auditors have the duty to attend board meetings as "members," but they are not board "directors," so they cannot vote — they can only state their opinions.

Kansayaku require no special training. They don't need to know how to read financial statements or know the law. Almost anybody can be appointed a kansayaku. Also, decisions taken at board meetings are not invalidated should the kansayaku fail to be in attendance.

The result is that while about 85% or more of all directors in the U.S. are independent outside directors, in Japan only 13.4% of all Tokyo Stock Exchange first-section companies have three or more outside voting directors — who need not be independent.

Richard Solomon publishes regular Beacon Reports at www.beaconreports.net