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Corporate Governance in Groups of Companies: A Perspective of Corporate Law and Securities Regulation

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Introduction

In this paper, I discuss basic legal infrastructure for corporate governance in the context of groups of corporations. Many laws and regulations relate to this area, but I focus on corporate law and securities regulation. The basic inquiry is whether corporate groups require a special response by law. With this inquiry in mind, I discuss the current legal responses in Japan, and compare them with their counterparts in other major jurisdictions. I try to draw the prescription for a desirable response in corporate law and securities regulation in Indonesia and elsewhere in order to ensure better corporate governance in the group context.

For lawyers, the topic of corporate groups is one of the most difficult ones. We all are aware of the existence (and increase) of corporate groups and the possible problems they produce, but we do not know how to regulate them by law. Thus, despite a strong interest in the academic circle, Japanese law remains rather silent. There are two more specific reasons for this silence in Japan. First, there seems to be no good set of rules we can import from elsewhere. For example, the German statutory rules on Konzernrecht seem unpopular in the world. Second, corporate groups may be of lesser concern in Japan, because unlike in some other countries, there are no dominant shareholders (which would typically be families) in Japanese public companies. Stock ownership in major public companies in Japan is dispersed. However, two problems must be distinguished: The first is that a group structure may aggravate so-called agency problems with the majority (or controlling) shareholders of the individual corporations. The other is that a corporate group may pursue the interest of the group, and not the interest of individual companies that comprise the group. The lack of dominant shareholders in Japan suggests that there should be less concern in Japan about the first problem, but the second problem remains relevant. I want to focus on this second problem in this paper. I might add that recent deregulation, particularly the amendments to the Anti-Monopoly Act in 1997, opened the door to creating a holding company structure in Japan, and in fact, many public companies have already moved to such structure. Thus, today, lawyers' interest in corporate groups is stronger than ever in Japan.

1. Status of Corporate Groups

A. Problem

Minority shareholders and creditors of member companies of corporate groups are (arguably) more vulnerable to the opportunism or negligence of controlling shareholders than minority shareholders and creditors of independent companies. This circumstance has led a few jurisdictions, most notably Germany, to develop a specialized set of legal rules

concerning corporate groups (called Konzernrecht in German law), and many other jurisdictions to address group-related issues pervasively in their corporate laws.

In general, corporate groups are multi-company structures dominated by "controllers," or powerful insiders, who may be the shareholders of a dominant company, coalitions of shareholders, or even cliques of influential managers. Under these settings, a group structure might adversely affect creditors and minority shareholders in two ways. First, such a structure might reduce transparency by blurring divisions between the assets of group members, and by suggesting (often wrongly) that the entire group stands behind each member's debts and more generally its activities. Second, a group structure allows controllers to set the terms of intra-group transactions, and thus to assign (and reassign) value within the group.

Sometimes an intra-group transaction is designed solely in order to extract value from the minority shareholders or creditors of a group member. More often, however, minority shareholders and creditors are injured by transactions that are undertaken for other reasons. For example, the entire group might gain a production, distribution, or tax advantage by shifting assets from one member to another, even though this shift makes the transferor's debt far riskier and thus injures its creditors (absent explicit guarantees from other group members). Minority shareholders are injured by similar transactions.

From the perspective of corporate governance, however, two problems must be distinguished. One is that a group structure aggravates agency problems (misbehavior of managers and/or majority shareholders) with each individual company. This problem can be dealt with by traditional corporate law. The other problem is that managers in a group may act for enhancing the value of the group, not the value of the individual company in the group. For the latter, the key question seems simple. That is whether managers and directors of an individual company of the group may act to maximize the interest of the group, or whether they must act to maximize the interest of their individual company. The answer to this question is not clear. The current law in most jurisdictions on this question is not clear, either. In reality, every corporate group can be viewed as forming one economic unit, but corporate law does not view it this way at all.

B. Difficulty in Definition

Identifying corporate groups is difficult. "Control" over the policies of group members (which is a necessary prerequisite of a group) is difficult to define. Voting agreements that create control blocks are often undisclosed, and simple rules based on a putative controller's voting rights can be misleading. For example, having control of a closely-held company might require 51% of its voting rights, while having control of a publicly-held company might only require 10% or 20% of its voting rights. Moreover, the law faces difficulty in recognizing some classes of corporate groups. Some kinds of groups may be obvious: for example, holding company structures, including U.S.-style public companies with wholly-owned subsidiaries, and family- or state-owned companies with multiple subsidiaries that are common in continental Europe; and dominant shareholder structures, in which companies are tightly linked together by cross-shareholdings and the largest company appears to lead (typical in Germany). However, other groups are more difficult to identify; some take form of a coalition structure in which several companies dominate a larger set of firms linked by cross-shareholdings (typical in France, Italy, and the

Netherlands); and others take form of a managerial structure, in which top managers exercise group-level control without a controlling shareholder coalition (which has been typical in Japan).

In Japan, the prohibition of "pure holding companies" by the Anti-Monopoly Act was lifted in 1997, and the amendments to the Commercial Code in 1999 and 2000 provided ways to move to a holding company structure easily. Since then, a holding company structure has been increasing in popularity. Today, most large banks and securities firms in Japan are subsidiaries of holding companies. Many non-financial firms are also under control of holding companies.

Although there is little consensus among jurisdictions as to how to regulate corporate groups as such, no country goes on to prohibit them outright. Indeed, even problematic structures such as corporate "pyramids" (groups controlled by minority shareholders through partly-owned holding companies) are generally permitted, despite the fact that they are the functional equivalent of super-voting stock, which is often prohibited outright. Such general acceptance suggests widespread appreciation of the possible efficiencies of group structures. In different settings, corporate groups can minimize taxes, efficiently allocate monitoring and risk-bearing costs among creditors and safeguard transaction-specific investments. In addition, at least one category of corporate group, a family holding company with a controlling interest in an operating company that also has minority shareholders, is the sole form of public ownership in much of the world.

Even though groups are not prohibited anywhere, they are heavily regulated in some (if not most) jurisdictions. At one extreme, Germany devotes both a specific section of its company law and substantial judicial attention to groups of companies. At the other extreme, U.S. courts largely ignore group structures. The UK, France and Japan fall between these extremes, since they lack an express set of law of corporate groups, but nonetheless have many statutory provisions and cases that address group-related issues. Finally, all major jurisdictions (including the U.S.) require at least some corporate groups to prepare consolidated financial statements for the benefit of minority shareholders and creditors.

2. Corporate Law

As indicated above, German group law (or Konzernrecht) provides the most elaborate and developed example of a group law that attempts to balance the interests of groups as a whole with those of the minority shareholders and creditors of their individual members.

German law distinguishes between "formal" contractual groups and de facto groups, or associations of companies that are in fact groups but do not acknowledge a collective identity. Contractual groups are based on a "contract of domination," which empowers corporate parents to instruct their subsidiaries to follow group interests rather than their own individual interests. As a quid pro quo, however, parent companies must indemnify their subsidiaries for any losses that stem from acting in the group's interests. Should this fail to happen, minority shareholders and creditors may attach the subsidiary's indemnification claim or sue the parent's directors for damages.

This same standard extends to groups of closely-held German companies (GmbH's) that are controlled by a single parent (qualifizierten faktischen GmbH-Konzerne). More

generally, even if a parent company has not entered into a contract of domination, it must compensate any subsidiaries that it causes to act contrary to the subsidiary's own interests. Should the parent fail to do so, minority shareholders and creditors may again sue the parent for damages.

The rule-based strategy of Konzernrecht contrasts with the more standards-oriented French approach to the same issues. Under French law, a group's controller need not pay compensation for instructing a member to act in the group's interest rather than in its own interest as long as the group is (1) stable, (2) pursuing a coherent business policy, and (3) distributing the group's costs and revenues equitably among its members. European experience thus far suggests that this French approach of focusing on the "enterprise" better reflects the actual practice of European group structures than the indemnification requirements of Konzernrecht. Apparently no one, including minority shareholders and creditors, takes the German indemnification rules seriously until a subsidiary is insolvent or close to it—at which point it is probably too late because the parent company is likely to be insolvent as well. As a result, skepticism about the German compensation rules seems widespread, which makes the French approach the leading model for European harmonization by default.

3. Securities Regulation

Today, all major jurisdictions (including the U.S.) require public corporations to prepare consolidated financial statements. More generally, all jurisdictions have moved toward the Anglo-Saxon accounting principles. Japan (under U.S. influence) and the EU (under UK influence) have adopted accounting methodologies based upon the "fair presentation" (or "true and fair view") principle. As a result, even Germany, which traditionally applied a more conservative "precaution" approach (Vorsichtsprinzip) to balance-sheet items, has moved closer to the Anglo-American approach. Nevertheless, important differences remain.

The traditional divergence between Anglo-Saxon and continental European accounting methods partly reflected differences in sources of external finance. U.S. and UK firms traditionally relied more on capital markets, which tend to penalize accounting opacity or conservativeness. Today, pressure from the international capital market, and the desire to access the U.S. equity market in particular, have forced the largest EU and Japanese firms to adopt accounting practices that are comparable to those used by U.S. firms. Indeed, U.S. securities law bars foreign companies that fully satisfy their home country disclosure requirements from selling securities to U.S. investors or listing securities on U.S. exchanges, without restating their results to accord with U.S. Generally Accepted Accounting Principles (U.S. GAAP), or providing a reconciliation between home country standards and U.S. GAAP.

While the details of the scope of consolidation and the exact content of disclosure must be carefully examined for each jurisdiction, it is fair to state that the mandatory disclosure requirement in securities law concerning consolidated financial statements is common today among major jurisdictions. If a corporate group includes a public company, the structure of such group will be disclosed by this method.

One problem is that consolidated financial reporting under securities regulation typically does not require disclosure of information about the controlling shareholder of a reporting company. Thus, if a family or an entity owned or controlled by the family stands behind the reporting company, information about such family or entity itself is not required to be disclosed in most jurisdictions.

Finally, from the corporate governance perspective, I would like to emphasize three general points about disclosure strategy. First, it is easy to say that disclosure is a good thing. Disclosure enhances transparency. Disclosure helps "stakeholders" of the firm or other market participants act properly. With adequate information, investors can buy or sell stock, have a "voice" with the management, or even acquire control of the company. Disclosure might prevent fraud. Despite these benefits, however, disclosure is accompanied by costs. These costs are placed on the firm that is required to make disclosure, and thus on the national economy. Therefore, when one pursues the improvement of the disclosure system, one must have a clear idea of exactly what sort of disclosure system to aim for. Indeed, it is extremely important to be aware of what information should be disclosed. Information being disclosed must be "useful," that is, understandable and verifiable. In this sense, determining what accounting rules should be adopted is particularly important. And auditing by professionals must be reliable.

Second, disclosure does not have an absolute value in isolation. The value, or the effectiveness, of disclosure depends very much on other (often non-legal or loosely legal) conditions, such as the style of finance and ownership structure. The value of disclosure is higher where there is a well-functioning capital market. It is also higher where investor ownership is dispersed rather than concentrated.

Third, from the corporate governance perspective, disclosure alone may not be enough, and other legal infrastructures are equally important for corporate governance to matter. For instance, even if the vast amount of information on public companies is available in the market place, if there are restrictive legal rules on corporate takeovers, the "market for corporate control" does not function as an effective corporate governance device. Therefore, when one considers the improvement of the disclosure system, one must also prepare a comprehensive regime of securities regulation to take the full advantage of the disclosure regime.

In sum, with regard to corporate groups, consolidation in financial accounting is popularly recognized in most jurisdictions in the world. However, information about the controlling shareholder of the reporting company is generally not required to be disclosed under securities regulation. Moreover, such consolidation is not recognized in corporate law. For instance, dividend regulation usually focuses on the profits of individual companies. As noted above, it is not clear whether managers and directors of an individual company of the group may maximize the interest of the group, or whether they must maximize the interest of their individual company. Even if the law attempts to view a group as one unit, it is not easy how to define it. In fact, the desirable scope of consolidation for the purposes of financial reporting may not be identical to that for the purposes of corporate law, for instance, regulating conflicts of interest activities.

4. Legal Framework in Japan

A. Statutes

Until 1997, the Anti-Monopoly Act prohibited "pure holding companies" per se. "Pure holding companies" are companies the purpose of which is to control other companies by holding shares of those other companies. The amendments to the Anti-Monopoly Act in 1997 lifted this ban, and it is now permitted to establish and manage such holding companies, subject to new regulation from the competition law perspective.

The Commercial Code (incorporating statutory rules of corporate law in Japan) was amended very often in recent years. In 1997, regulation on mergers and consolidations was liberalized. In particular, regulation for creditor protection was liberalized, and individual notices to creditors are now not required in mergers or consolidations. Also, as a result of this amendment, a merger in a small scale does not require shareholder approval.

In 1999, the system of "share exchange" was introduced. This was a response to the abolishment of prohibition of holding companies in Anti-Monopoly Act. Specifically, a share exchange is a mechanism for creating a parent company, and thus permitting a move to a holding company structure more easily. Suppose that Listed Company X wants to create Holding Company H and become its 100% subsidiary by making H a listed company. Before the 1999 amendments, there was no easy way of accomplishing this goal. Now, X can engage in a share exchange transaction, by which all X shares are exchanged by H's shares upon a special resolution at the shareholders' meeting of X. The resolution binds dissenting shareholders, whose only remedy is the appraisal right (the right to have the shares purchased by the company at a fair value). In connection with the system of share exchange, some amendments to enhance protection of shareholders of the parent company (including a holding company) by strengthening disclosure were made (see below).

In 2000, the procedure for corporate divisions (known as *Abspaltung* in Germany) was introduced. Suppose that Company Y has a toy division and a movie division. Y now can divide and put its toy division into a different company, which I will call Z for the purposes of illustration. Z may be newly created or may already exist. The genesis of the procedure is that once Y makes the decision by a special resolution at its shareholders' meeting, its toy division (which must constitute a business as such under the new corporate law) will be transferred into Z with both its assets and liabilities belonging to the division. There is no need to obtain approval from the individual creditors of the debts being transferred. The creditors' only remedy is the right to collateral, as in mergers, and they cannot stop the divisive transaction. A special companion statute was enacted to protect employees, requiring, among other things, that the company must consult with its employees in advance. Another point is that if Y were to transfer its division to Z through an "investment in kind", inspection by a court-appointed examiner would be required as a general rule in corporate law. However, a "corporate division" does not require this costly and time-consuming process.

There are several statutory rules in Japanese corporate law that may relate to corporate groups. First, subsidiaries are generally prohibited from acquiring the shares of their parent company (Art. 211-2). While repurchase of own shares was deregulated in 2001, prohibition on the purchase by the subsidiary of its parent shares remains. Second, mutual stockholding is subject to voting restrictions. Specifically, if more than 25% of Company A's shares are owned by Company B, Company A is prohibited from exercising voting rights with the shares of Company B it holds (Art. 241(3)). Third, companies are prohibited from making payments in connection with exercise of shareholder rights, and companies are also

prohibited from making payment through their subsidiaries (Art. 295). Fourth, statutory auditors (*kansayaku*) are prohibited from serving as directors, officers or employees of the subsidiary (Art. 276) and an auditor's right to investigation reaches subsidiaries (Art. 274-3). Financial auditors (CPA) are given similar rights. Fifth, amendments in 2002 introduced consolidated financial statements, which were already required under securities regulation, but are now also required under corporate law. This means that companies must prepare consolidated financial statements, have them audited, then submit them together with the audit opinions at annual shareholders' meetings. Finally, shareholders of a parent company have the right to inspect books, records, financial data and the minutes of board and shareholder meetings of a subsidiary if they obtain permission from the court.

With respect to the controlling shareholder of a public company, the Securities and Exchange Act in Japan currently requires disclosure of information concerning ownership of such shareholder and major transactions between the reporting company and the controlling shareholder, but does not require disclosure of information concerning the controlling shareholder itself. The Act was thus amended in June, 2005 (effective from the report regarding the fiscal year beginning after April 1, 2006) and disclosure of such controlling shareholder itself (specifically, information on the ownership structure of such controlling entity, its executives, and its financial statements) will be required. The limitation in this new scheme remains, however. A controlling entity (of a public company) subject to this new disclosure requirement is limited to incorporated bodies and does not include individuals or investment funds.

B. Cases

In general, while we have seen many developments of case law in Japan with regard to the duty of care of managers and directors, there are no distinctive case law developments in the area of "duty of loyalty". However, first, beginning in the 1980s, some courts did begin to apply the duty of loyalty provision (Art. 254-3 of the Commercial Code) independently from other provisions in certain situations (see Tokyo High Court Judgment of October 26, 1989 *Kinyu Shoji Hanrei* 835-23). Note that director civil liability based on this provision uses the negligence rule in Japan (Art. 266(1)(v)). Second, there are specific provisions, violations of which result in the strict liability of directors. The most well known provision is Art. 265, which prohibits self-dealing by directors. These provisions were applied sometimes in the context of corporate groups. Under Art. 265, directors were held liable in a case where the same person was the CEO of two companies and one of the companies sold land to the other company (Supreme Court Judgment of October 20, 2000, *Minshu* 54-8-2619 (though the major issue before the Supreme Court was a technical discharge issue)). In contrast, directors were not held liable in a case where a loan was extended to the company's affiliate through a third party, on the ground that extending such loan does not fall within the definition of self-dealing under Art. 265 (Osaka District Court Judgment of January 30, 2002, *Hanrei Taimuzu* 1108-248). In my view, the point here is that the violation of Art. 265 produces strict liability (Art. 266(1)(iv)), but the Osaka District Court avoided applying the strict liability test.

5. Issues Debated in Japan

Today in Japan, there are a few distinctive issues that are often focused on and debated about in connection with law of corporate groups. The first issue is whether holding companies, particularly pure holding companies, are special, from the perspective of

corporate law. Indeed, as pure holding companies do not conduct any activities, they seem to be simple boxes with nothing in them but shares of subsidiaries. The shareholders of such holding companies should thus be interested in the activities of their subsidiaries, but corporate law is not designed to permit them direct rights toward subsidiaries (with a few exceptions, including the right to information as noted above). Thus, some argue that in general, shareholders of pure holding companies are different from those of other companies.

Second, as noted above, as a fundamental issue, under current corporate law in Japan, it is not clear whether managers and directors of an individual company of the group may maximize the interest of the group, or whether they must maximize the interest of their individual company. Court cases in the past year show that parent companies may spend their own resources to rescue their subsidiaries if they are in financial trouble (suggesting that managers of parent companies may maximize the interest of the aggregate of parent and subsidiary companies). However, there is no statutory provision or case law that explicitly permits managers and directors of an individual company of the group to maximize the interest of the group. It is far less clear under current corporate law in Japan that if such pursuit of the interest of the group is permitted, under what conditions it is permitted. These questions are of particular importance where the company in question is not at the top of the group, but located in a lower tier in the group, typically a subsidiary.

Third, most corporate groups in Japan undertake activities across the country border, and thus it is typical for large public companies in Japan to have subsidiaries and affiliates outside Japan. In this context, a legal question arises whether Japanese statutory rules regulating subsidiaries apply to subsidiaries incorporated outside Japan. For instance, does prohibition on subsidiaries from obtaining shares of their parent apply to subsidiaries incorporated outside Japan? Do auditors and CPAs have the right to inspect subsidiaries incorporated outside Japan? Traditionally the answer to these questions was rather negative, but the new Company Act (passed in 2005 and effective from May, 2006), which consolidates all the existing statutes concerning corporate law, takes the position that the answer should be yes.

Fourth, the role of stock exchanges has been under discussion in the past few months. In particular, Tokyo Stock Exchange recently delisted two public companies on the ground that they violated disclosure rules, and although delisting was by no doubt an effective means of sanction, it also produced losses to the public investors of those companies as a result of delisting. In these two companies, new management was in place and cleaned up the mess in the past. The debate is thus whether in such circumstances delisting is desirable.

6. Conclusion

The topic of corporate groups is one of the most difficult ones. We are all aware of the existence (and increase) of corporate groups and possible problems they produce, but we do not know how to regulate them by law. From the perspective of corporate governance, however, past experience in Japan and elsewhere shows two general principles that should apply to corporate groups from perspectives of corporate law and securities regulation. First, disclosure of financial conditions as well as intra-group transactions and related matters help enhance transparency of the group in question and thus better inform investors and other parties concerned. For such disclosure to be meaningful, other infrastructure is important, such as reliable auditors and the existence of the market for corporate control. Second, intervention by corporate law seems to provide for protection of shareholders of parent

companies, minority shareholders of subsidiaries and creditors of subsidiaries. In this context, two problems must be distinguished. One is that a group structure aggravates agency problems (misbehavior of managers and/or majority shareholders) with each individual company. This problem can be dealt with by traditional corporate law. The other problem is that managers in a group may act for enhancing the value of the group, not the value of the individual company in the group. Here, the key question is whether managers and directors of an individual company of the group may maximize the interest of the group, or whether they must maximize the interest of their individual company. True, at the group level, enhancing the value of the pie should be distinguished from the division of the pie. However, these two aspects are often related to each other, and we know little about whether corporate law can play any role for an entity it does not recognize.

NOTE

*/ Part of this paper draws from Reinier Kraakman et al., *The Anatomy of Corporate Law* (2004, Oxford University Press). An earlier version of this paper was presented at a conference by the Korean Development Institute in November, 2004.