

Introduction: the incentive bargain of the firm and enterprise law: a nexus of contracts, markets, and laws

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I.1 INTRODUCTION

The firm is an ongoing joint project requiring both financial and human capital. Like other joint projects, the firm cannot maximize its value added without achieving an efficient “incentive bargain” between its indispensable capital providers, that is, the shareholders and creditors that act as monetary capital providers, along with the management and employees that act as human capital providers (“the four capital providers”).¹ The incentive bargains can be defined as the bargain between the indispensable capital providers of the firm which motivates each actor to provide the capital they own to the joint project, including the bargains for sharing control and the bargains for sharing the firm’s value added. The result of a successful incentive bargain is that each capital provider has the optimal incentive to maximize the firm’s value added.

To understand how law influences the firm’s practices, we need an account and theory of “enterprise law,” broadly defined to include the entire range of private contracts and public regulations governing the relationship of these different capital providers. This chapter will illustrate the incentive bargain of the firm by focusing on the interrelationships and complementarities between different institutions, such as markets, social norms and laws. I will also consider some related legislative policy implications.

The legal system is an important infrastructural element of the firm’s incentive bargain. Those parts of the legal system that affect the bargaining between the participants in the firm we call “enterprise law.”

¹ ZENICHI SHISHIDO, *DOKIZUKE NO SHIKUMI TOSHITENO KIGYO: INSENTHIBU SHISUTEMU NO HOSEIDO RON* [THE FIRM AS AN INCENTIVE MECHANISM: THE ROLE OF LEGAL INSTITUTIONS] 1 (2006).

Enterprise law specifically includes corporate law, securities regulation, bankruptcy law, labor law, tax law, and other areas of law (intellectual property law, antitrust law, etc.). In general, each part of enterprise law works complementarily with other parts of enterprise law, including in respect to enforcement systems.

Enterprise law affects bargaining between the four capital providers in three ways. First, it may directly affect the incentive of a specific player.² Second, it may affect the relative bargaining power between two players and consequently increase or decrease the risk borne by each player.³ And third, it may affect the coalition between two players.⁴

The important point to understand is that law is not always effective in its attempt to affect the incentive bargain between the four capital providers by itself, but instead works to affect the incentive bargain by interacting complementarily with markets and social norms. In order to elucidate the interaction between markets, social norms, and laws, this chapter focuses on the United States and Japan, and comparatively analyzes the way these infrastructures complement each other in both regions; brief references to other jurisdictions are also made. The object of this chapter is to answer the question of how to structure a legal system in a way that stimulates efficient incentive bargaining at the firm level by indicating the right direction for legislative policy, and consequently, enhancing the efficiency of the whole economy.

In section I.2, a framework is introduced to facilitate viewing the firm as an incentive mechanism between the four capital providers and the government as a given infrastructural component. Additionally, three basic “incentive patterns” are set forth and each of the four capital providers are further divided into two subcategories for the purpose of analyzing the effects of the relevant market on each provider. Section I.3 describes issues related to the incentive bargain between employees and management and demonstrates how the liquidity of the external labor market, social norms, and employment protection laws complementarily

² For example, subjecting management to strict liability will give management an incentive to take less risk. See *infra* notes 111–112, 169 and their accompanying text.

³ For example, shareholders’ voting rights provided for by corporate law strengthen shareholders’ bargaining power with management and decrease the risk of providing monetary capital to corporations. See *infra* note 85 and its accompanying text.

⁴ For example, strong employment protection laws encourage employees and management to create a coalition. See *infra* notes 28–29 and their accompanying text. See, also, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multiple-Player Game*, 78 *Geo. L. J.* 1495 (1990).

affect the other bargaining relationships, particularly as between shareholders and management; the roles of labor unions during renegotiations in the US and Japan are also compared. In section I.4, issues related to the incentive bargain between creditors and management are described. The most important issue here is renegotiation in insolvency-related scenarios. This section demonstrates why laws matter in both private and legal reorganization processes and how laws affect the *ex ante* incentives of the relevant providers. In section I.5, issues related to the incentive bargain between shareholders and management are described by dividing the wide range of issues into three parts: laws which encourage or discourage shareholder activism, particularly by institutional investors; legal regulations applicable to control transactions in respect of both buyers and sellers; and the problem of cross-shareholding in Japan and the potential for its regulation via the Japanese legal system. Section I.6 describes the role of government and its incentive effects, particularly its role in taxation and regulation, as an exogenous factor on the incentive bargain of the firm. Finally, in section I.7, as a conclusion, an overview of this chapter is provided where the incentive bargain of the firm is thought of as a repeated game. The chapter also proposes an approach to legislative policy that may lead to increased efficiency of the incentive bargain of the firm.

I.2 THE FIRM AS AN INCENTIVE MECHANISM

I.2.1 The Incentive Bargain

The firm can be understood as an incentive mechanism between those who provide human capital (management and employees) and those who provide monetary capital (shareholders and creditors). Each of the four groups provides capital that is crucial to their collective enterprise. Should one group fail to provide that capital, the enterprise will suffer. According to contracts negotiated from the outset, the four groups of participants also share the returns that arise out of the activity of the firm. Therefore, the groups try to use the firm structure to give each other incentives to invest in a way that maximizes the firm's value added and consequently maximizes their own payoff.

There are conflicting interests between the four players and each player will face certain risks based on such conflicting interests. If the players leave those risks (that is, both their own risks and other players' risks) as they are, the incentive of the players to provide their own capital to the joint project will be distorted. As such, the four players try to incentivize

each other through bargaining over sharing control to decrease risk, and sharing value added as a positive incentive.

The most fundamental conflicting interests, the one that represents the largest risk for all four players, is the conflict between the autonomy of the human capital providers and the monitoring power of the monetary capital providers. The human capital providers use the funds provided by the monetary capital providers to create value. Therefore, the human capital providers seek more autonomy while the monetary capital providers want more monitoring power in respect of how their funds are used.⁵ The risk to the monetary capital providers is that the human capital providers may waste the money that was provided; the risk to the human capital providers is that the monetary capital providers may retrieve the control right of assets of the firm. It is important to reach a bargain that sets up a good balance between the autonomy of the human capital providers and the monitoring power of the monetary capital providers (hereinafter, I will call this “the balance between autonomy and monitoring”).⁶

The incentive bargain of the firm is always negotiated via management, which functions as the sole bargaining window, although a coalition may be formed between some of the four players. Therefore, there are three bargaining relationships in the firm: that between employees and management; that between creditors and management; and that between shareholders and management (see Figure I.1). We can observe various interactions among these bargaining relationships.

1.2.2 Three Incentive Patterns and Divergence of Internalized Governance

The differences between the “functional corporate governance” practices of different countries will be revealed as resulting from differences in the “incentive bargaining” practices between the four players in these countries, particularly in the way coalitions are constructed among the four players. There are three different incentive patterns in publicly held companies, specifically: the balancing image, monitoring image, and bargaining image incentive patterns.⁷

⁵ See SHISHIDO, *supra* note 1, at 38; Zenichi Shishido, *Reform in Japanese Corporate Law and Corporate Governance: Current Changes in Historical Perspective*, 49 AM. J. COMP. L. 653, 654 (2001).

⁶ Such balancing is inevitable in many issues of legislative policies. See e.g., Benjamin E. Hermlin, Chapter 19 in this volume: “Presumably, an optimal amount of transparency exists that balances benefits and costs.”

⁷ See SHISHIDO, *supra* note 1, at 169.

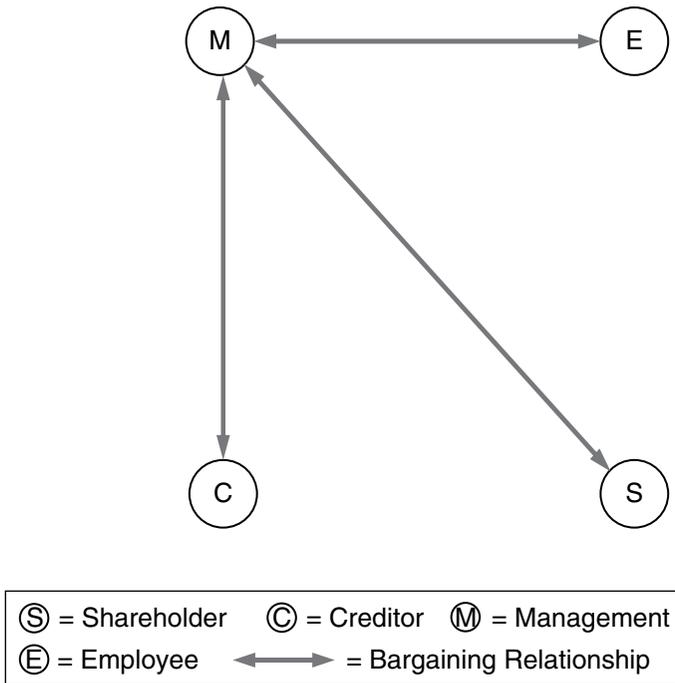


Figure I.1 The four players and three bargaining relationships in the firm

In the convergence of corporate governance debate,⁸ diversity of stock ownership is generally regarded as a criterion for functional convergence.⁹ However, the most fundamental aspect of a functional corporate governance system, which can be chosen by the players under certain exogenous

⁸ See Lucian Bebchuck & Mark Roe, *A Theory of Path Dependence in Corporate Governance and Ownership*, 52 *STAN. L. REV.* 127 (1999); J. Mark Ramseyer, *Are Corporate Governance Systems Converging?* (Working Paper, 1998); Ronald Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 *AM. J. COMP. L.* 329 (2001); John Coffee, Jr., *The Future as History: The Prospects for Global Convergence and Its Implications*, 93 *Nw. U. L. REV.* 641 (1999); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 *GEO. L. J.* 439 (2001). Contrary to the prediction of and the recognition by these knowledgeable convergence theorists (*see id.*), however, “there is little sign that Japanese corporate governance practices are being fundamentally transformed or rapidly ‘converging’ with those of the United States.” See Curtis Milhaupt, *The Lost Decade for Japanese Corporate Governance Reform?: What’s Changed, What Hasn’t, and Why* (Working Paper 2003).

⁹ See Bebchuck & Roe, *supra* note 8, at 127.

conditions, is how to motivate monetary capital providers and human capital providers to invest their own capital in the firm; this aspect is hereinafter referred to as an “incentive pattern.” Diversity of stock ownership (and liquidity of stock markets) is simply one of the exogenous factors which restricts the choice of incentive pattern.¹⁰

The optimal internalized governance system – that is, incentive patterns – will diverge depending upon exogenous factors, namely markets (capital, labor, and product), social norms, and laws. There is also the possibility of the coexistence of multiple internalized governance systems in a single country, depending upon the industry sector and the growth stage of the company. Different degrees of significance of firm-specific investment in each industry sector will be particularly influential on the choice of optimal internalized governance system.

Balancing image

The most basic incentive pattern is the “balancing image,” in which, while there is no coalition between the players, each player monitors management to ensure that their “promises” to the players are met. Management will accordingly try to balance the pressure from different players and, as a consequence, run the firm toward the direction in which the compound vectors of monitoring points (see Figure I.2).¹¹ The length of each vector, which indicates the amount of pressure, depends on the overall bargaining power of the relevant player, which is in large part determined by markets, social norms, and laws.¹²

The number of players and the complexity of the conflicting interests that arise among them increases as the size of the firm increases. It will also be costly to create and maintain coalitions between different types of players as a firm grows. In this sense, the balancing image is the basic incentive pattern utilized by listed companies and is well adapted for flexibly balancing various interests on an ongoing basis. In many

¹⁰ See Zenichi Shishido, *The Turnaround of 1997: Changes in Japanese Corporate Law and Governance*, in *CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY* 310, 323 (Masahiko Aoki et al. eds., 2007). Although diversity of stock ownership in each jurisdiction is an exogenous condition, management can still generally change the ownership structure of companies. In this sense, diversity of stock ownership has endogenous aspects.

¹¹ See Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of the Corporate Law and Their Solutions*, 25 *DEL. J. CORP. L.* 189, 194 (2000).

¹² Corporate law makes the vector representing shareholders longer by giving them voting rights, which collectively can be used to replace management. See *id.*, at 194.

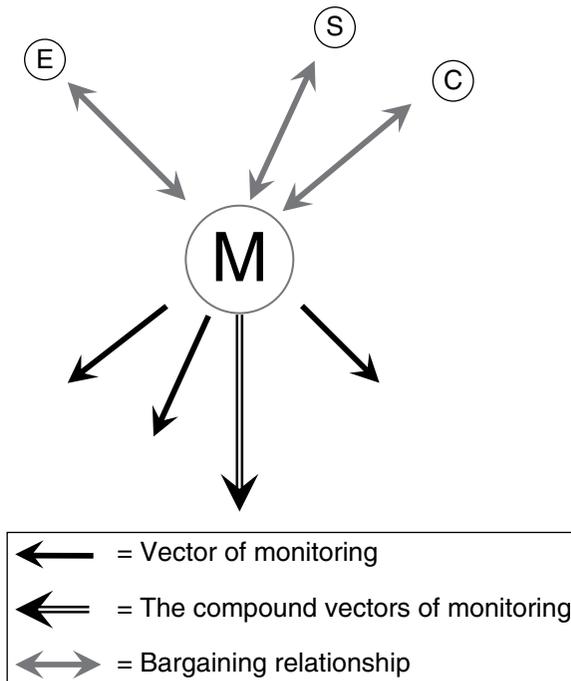


Figure I.2 *Balancing image*

respects, this is similar to Berle and Means's "management control" company.¹³

A problem with the balancing image is that management is not necessary neutral but has its own private benefit. Although corporate law provides procedural regulations to combat conflict-of-interest transactions, such as limitations imposed on managerial compensation, and the fiduciary duty imposed on management in general, it remains difficult to prevent management from empire building.

Monitoring image

The second incentive pattern is the "monitoring image," in which shareholders and management create a coalition, while the other players, that is, creditors and employees, are motivated through markets and not involved in corporate governance (see Figure I.3).

¹³ See ADOLF A. BERLE & GERDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

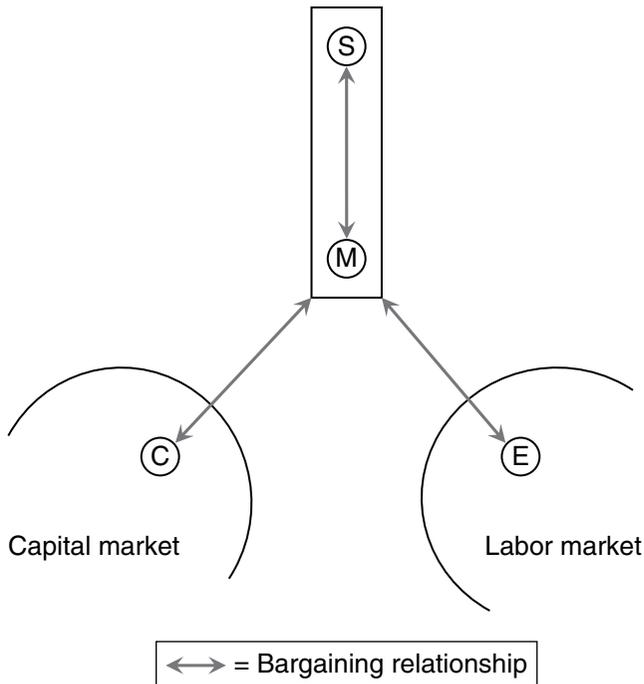


Figure I.3 Monitoring image

In most listed companies in the US, the incentive bargain seems to be in line with the monitoring image (the A-model).¹⁴ In the US, the so called “agency model,” in which shareholders, as owners, monitor their agent, management, in an effort to ensure that the firm is being run in the best interest of the shareholders, turns into a social norm, which in turn sustains the coalition between shareholders and management.¹⁵ Incentive pay systems, such as stock options,¹⁶ are attempts to align management’s inter-

¹⁴ See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 69 (1991); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991); Manuel A. Utset, *Towards a Bargaining Theory of the Firm*, 80 CORNELL L. REV. 540, 550 (1995).

¹⁵ See Kenneth G. Dau-Schmidt & Benjamin C. Ellis, Chapter 3 in this volume.

¹⁶ As a result of tax law, management will generally prefer compensation packages based on stock options and other incentive compensation rather than guaranteed salaries. See David Gamage & Shruti Rana, Chapter 15 in this volume.

ests with shareholders' interests.¹⁷ The existence of liquid capital markets and liquid external labor markets are necessary for the monitoring image to work efficiently.¹⁸ The monitoring image seems to suit those businesses in which firm-specific investments are not very important, such as those in the financial industries.¹⁹

Bargaining image

The third incentive pattern is the "bargaining image," in which monetary capital providers and human capital providers organize into two teams, and these two teams bargain with each other via their representatives in an attempt to motivate each other to invest their respective monetary and human capital (see Figure I.4).

The typical bargaining image can be found in venture capital investments in Silicon Valley (the Silicon Valley model). In the Silicon Valley model, the lead venture capitalist, as the representative of the monetary capital providers, bargains with the founder of the start-up company, as the representative of the human capital providers.²⁰

Another typical bargaining model is the Japanese main bank model (the J-model).²¹ In the J-model, the chief executive officer (CEO) of the main

¹⁷ Even with liquid external labor markets for executives, executive compensation is a controversial issue and considered by many to not accurately reflect the ability of CEOs in the US. See LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

¹⁸ In countries with liquid external labor markets, such as the US, the social norm of maximizing shareholder value is accepted relatively easily. See JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE*, Ch. 1 (2006).

¹⁹ A typical example is the American investment bank. Particularly, the existence of liquid labor markets for investment bankers is a key factor to the success of American investment banks. It is difficult for Japanese investment banks to follow the monitoring image incentive pattern because external labor markets for investment bankers are not sufficiently liquid in Japan.

²⁰ See Zenichi Shishido, *The Law and Practice of the Venture Industry in Japan: A Period of Transition*, in *THE JAPANESE LEGAL SYSTEM: AN ERA OF TRANSITION* 193, 194 (Tom Ginsburg & Harry N. Scheiber eds, 2012).

²¹ See Tetsuji Okazaki, *Nihon niokeru Koporeto Gabanansu no Hatten [The Development of Corporate Governance in Japan]*, in *SHISUTEMU TOSHITENO NIHON KIGYO [JAPANESE ENTERPRISES AS A SYSTEM]* 456 (Masahiko Aoki & Ronald Dore eds., 1995); Shishido, *supra* note 5, at 663. *But see* Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank*, 27 *LAW & SOC. INQUIRY* 401 (2002). Although the significance of the main bank system has been decreasing since its heyday in 1960s and 1970s, it still plays an important role particularly for companies which have no access to the bond market. See Yasuhiro Arikawa & Hideaki Miyajima, *Relational Banking in Post-Bubble Japan: Co-existence of Soft-*

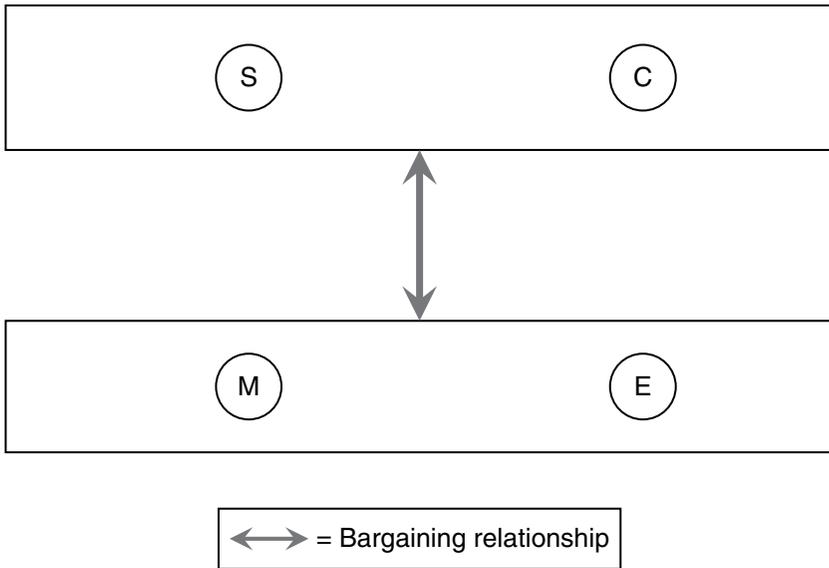


Figure I.4 Bargaining image

bank, as the representative of the monetary capital providers, bargains with the CEO of the borrower company, as the representative of the human capital providers.

The bargaining image incentive pattern cannot be maintained when the cost of creating and maintaining a coalition between human capital providers and between monetary capital providers becomes too expensive. In Japan, illiquid external labor markets for both employees and management, strong employment protection laws, and the “company community” social norm have complementarily contributed to the prevalence of coalitions between management and employees.²² Cross-shareholding can also be seen as a scheme to strengthen coalitions between monetary capital providers.²³ The bargaining image seems to suit those industries in which firm-specific investments are important, such as the car manufacturing industry.²⁴

and *Hard Budget Constraint*, in *CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY* 51 (Masahiko Aoki et al. eds, 2007).

²² See *infra* notes 32–33 and their accompanying text.

²³ See *infra* notes 34–35, 128–129 and their accompanying text.

²⁴ Typical examples are Japanese car makers, such as Toyota, Nissan, and Honda. It would be difficult for GM and Ford to choose the bargaining image

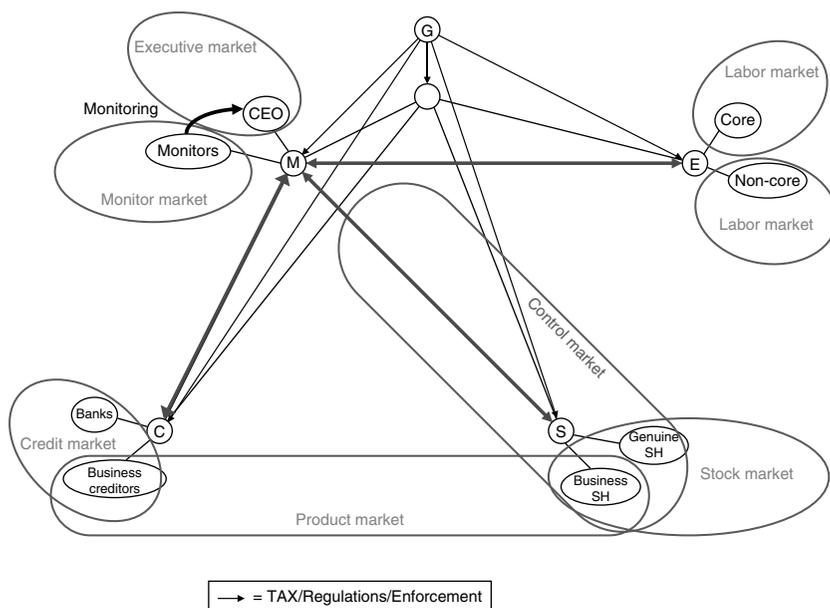


Figure I.5 Government, two categories for each of the four players and their relevant markets

I.2.3 Government, Categories of Each Player, and Relevant Markets

In addition to the four players, the government also provides crucial foundational services (not only physical infrastructure, but also the legal system including public enforcement), and has an interest in the returns on firms' activities through its tax regime. Therefore, we should also consider government as the fifth participant in the incentive bargain of the firm. In this analysis, however, the government does not act as a fifth player in the game. Instead I will treat taxation, regulations, and enforcement, which are provided by the government, as given foundational components of the incentive bargain between the four players.

Although I have already identified the four indispensable capital providers of the firm – that is, management, employees, shareholders, and creditors – it is necessary to further divide each player into two subcategories, at least for the purpose of analyzing the effects of the relevant market on each player (see Figure I.5).

incentive pattern because of the adversarial labor management relationships commonly found in the US.

Specifically, management can be divided into executives, particularly CEOs, and monitors, such as independent directors. Although the CEO and independent directors constitute the board and make important business judgments together, the CEO initiates and executes business plans, and independent directors ratify the plans and review the results of their execution. Because of these different roles of management, the incentives of and markets for CEOs and independent directors are different.

Employees can be divided into core employees and non-core employees.²⁵ The labor market, which influences employee incentives, can also be divided into the labor market for core employees and that for non-core employees.

Creditors can be divided into secured creditors, such as banks, and unsecured creditors, such as most business creditors and most bondholders. The credit market influences the incentives of both banks and bondholders, while the incentives of the business creditor are mainly influenced by the product market.

Shareholders can be separated into genuine shareholders and business shareholders.²⁶ The stock market influences the incentives of both genuine shareholders and business shareholders. The incentives of business shareholders are also influenced by the product market. Both types of shareholders create the control market, which influences the incentives of both types of shareholders.

I.3 INCENTIVE BARGAIN BETWEEN EMPLOYEES AND MANAGEMENT

I.3.1 Coalition between Employees and Management

Although the media often focuses on the adversarial relationship between employees and management, such as can be seen during labor disputes, it is in fact more common for management and employees to create a coalition because they share the same interest in their role as human capital

²⁵ Core employees have their own value in the labor market. Non-core employees are provided by the labor market as commodities.

²⁶ Genuine shareholders, such as institutional investors, buy and sell stocks, and exercise their voting rights solely in consideration of maximizing their investment return. Business shareholders place a higher priority on their business relationship with the issuing company rather than on maximizing their investment return. Most business shareholders are cross-holding shareholders in Japan. See *infra* notes 141–143 and their accompanying text.

providers, that is, to maintain their autonomy from monetary capital providers, particularly “genuine shareholders.”²⁷ Long-term employment contracts effectively transform employees into a “shark repellent”²⁸ and employees will frequently act as “white squires” to the extent that they are not protected by long-term contracts against the risk of wage cuts by corporate raiders.²⁹ Management also has an incentive to set up an employee share ownership plan (ESOP) as a defensive device.³⁰ Employees may deter hostile takeovers, not only by being stable shareholders, but also by lobbying against the raider.³¹

²⁷ See Martin Hellwig, *On the Economics and Politics of Corporate Finance and Corporate Control*, in *CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES* (Xavier Vives ed., 2000); Marco Pagano & Paolo Volpin, *Managers, Workers, and Corporate Governance*, 60 *J. FIN.* 841, 842 (2005).

²⁸ The abusive dismissal rule not only strengthens the management’s bargaining power against shareholders (see *infra* notes 41–45 and their accompanying text), but also makes the existence of full-time employees a shark repellent because even new management cannot discharge surplus labor easily. In addition to the abusive dismissal rule, other Japanese labor law rules have similar shark repellent effects. It is not easy for new management to change the salary system in a way which is unfavorable for employees (Labor Union Act Article 16; *In re Asahi Fire Marine Insurance*, 713 *ROHAN* 27 (Sup. Ct., Mar. 27, 1997); *In re Daiyon Bank*, 51-2 *MINSHU* 705 (Sup. Ct., Feb. 28, 1997)), or make employees work overtime (Labor Standards Act Article 36), if labor unions do not agree. As a result, labor unions are able to exert bargaining power against corporate raiders.

²⁹ Pagano & Volpin, *supra* note 27, at 842. Although Japanese employment protection and labor law rules strongly protect employees against the risk of wage cuts by the raider, Japanese employees almost always act as white squires. Particularly in cases of hostile takeovers, Japanese enterprise unions almost always declare their support for incumbent management and against the raider. See e.g. *NIKKEI*, Aug. 3, 2006, at 3 (Hokuetsu Paper case).

³⁰ In the US, ESOPs have grown dramatically in number, from 1601 in 1974 to 11 500 in 2000. The Business Combination Statute implemented in Delaware in 1987 enhanced the anti-takeover effect of ESOPs. See Pagano & Volpin, *supra* note 27, at 859.

Also in Japan, a broad-based employee stock purchase plan (ESPP) is prevalent among listed companies. Although employee shareholders have private benefits in their employer corporation and are stable shareholders for management, it may improve productivity complementary with certain corporate culture or employment practices. The current Japanese legal framework, which shows a favorable attitude towards ESPPs by providing specific regulatory exemptions without providing tax advantages, is probably a realistic and reasonable choice. See Yohsuke Higashi, Chapter 4 in this volume.

³¹ Pagano & Volpin, *supra* note 27, at 859, 863.

Particularly in Japan, the practice of lifetime employment,³² the lack of liquid external labor markets, and the existence of strong employment protection laws complementarily support the coalition between employees and management, which has become known as the “company community.”³³ In addition to the coalition between employees and management, the coalition between business shareholders,³⁴ who are mostly cross-holding shareholders,³⁵ and management is well organized in many Japanese companies, and both types of coalitions act as an alliance against genuine shareholders.

I.3.2 Liquidity of External Labor Markets and Choice of Incentive Patterns

Japanese labor markets are unique in two ways. First is the illiquidity of external labor markets both for core employees and for management. Second is the combination of internal labor markets for core employees and for management. In other words, the turnover rate of core employees is low and management is usually chosen from among core employees via in-house promotion.³⁶ As a result, incumbent management and core employees share the same identity and both groups invest their energies to maintain a good reputation within the firm. It is also understandable that these groups would try to prevent raiders’ interventions in order to preserve the human capital they have invested and the implicit contracts between them. Illiquid external labor markets and the company community norm affect each other and complementarily support the choice of the bargaining image incentive pattern.³⁷

In the United States, liquid external labor markets and the shareholder value maximization norm affect each other and complementarily support

³² Although the prevalence of lifetime employment is decreasing, various studies show that it is still the norm at a majority of Japanese companies, which are often reluctant to lay off employees in times of economic downturn when compared to companies in other countries. See TAKASHI ARAKI, *LABOR AND EMPLOYMENT LAW IN JAPAN* 21 (2002).

³³ See Shishido, *supra* note 11, at 201.

³⁴ In general, long-term contracts with suppliers can serve as anti-takeover devices. See Pagano & Volpin, *supra* note 27, at 843.

³⁵ See *infra* notes 128–129 and their accompanying text.

³⁶ To administer such an internal labor market, the human resources department of each Japanese company plays an important role. See SANFORD M. JACOBY, *THE EMBEDDED CORPORATION: CORPORATE GOVERNANCE AND EMPLOYMENT RELATIONS IN JAPAN AND THE UNITED STATES* 21–40 (2005).

³⁷ See *supra* notes 22–23 and their accompanying text.

the choice of the monitoring image incentive pattern.³⁸ The negative externalities exerted by shareholder control on employees are smaller in countries with liquid external labor markets, where the norm of shareholder value maximization is less controversial.³⁹

I.3.3 Dismissal Rules and their Spillover Effects

Rules relating to dismissal of employees are some of the most divergent when comparing US law and Japanese law. In the United States, the general position is that management can discharge employees without cause (the employment-at-will rule).⁴⁰ In Japan, management cannot discharge employees without good cause, which has been strictly interpreted by the courts (the abusive dismissal doctrine).⁴¹

Rules relating to dismissal will affect the incentive bargain of the firm, not only between employees and management, but also between all four players.⁴² Strong employment protection will also have spillover effects on corporate governance.

Although the abusive dismissal rule was originally created to protect employees and has supported the practice of so-called “lifetime employment,”⁴³ it not only strengthens employees’ bargaining power with management, but also strengthens management’s bargaining power with shareholders because it gives management a good excuse to decrease dividends during company’s downturns rather than laying off employees.⁴⁴ In fact, the abusive dismissal rule, company community norms, and the lack of a liquid external labor market have complementarily transformed directors’ fiduciary duties under Japanese corporate law.⁴⁵

³⁸ See *supra* notes 14–18 and their accompanying text.

³⁹ See TIOLE, *supra* note 18.

⁴⁰ Even in the US, however, it is a risky event for employers to dismiss employees because there are statutory and common law exceptions to the employment-at-will rule, particularly, termination based on racial or gender discrimination is prohibited. See J.H. Verkerke, Chapter 1 in this volume.

⁴¹ See Ryuichi Yamakawa, *Changing Aspects of Japanese Dismissal Law*, in *LAW IN JAPAN: A TURNING POINT* 483 (Daniel H. Foote ed., 2007).

⁴² See Toru Kitagawa, Chapter 2 in this volume.

⁴³ The abusive dismissal rule was originally based in case law. It became statutory law in 2004. See Labor Contract Act Article 16.

⁴⁴ See Kitagawa, *supra* note 42.

⁴⁵ See *id.*

I.3.4 Renegotiations and the Role of Labor Unions

From the outset, some renegotiation is expected between employees and management. Labor law provides rules for such renegotiations, for example the “collective bargaining” rule, in which labor unions play an important role.

When renegotiation is expected, the hold-up problem occurs.⁴⁶ Parties with less bargaining power, employees in this case, expect that they will be forced to accept unfavorable changes to their current contracts, and as a result, their incentive to continue to invest human capital becomes distorted. Mandatory legal regulation is necessary not only for protecting employees but also for providing an infrastructure that facilitates efficient incentive bargaining, by making it possible for management to commit to not breaching their agreements.

In the United States and in EU countries, labor unions are industry-wide unions organized on a national basis, while Japanese labor unions are typically enterprise-specific unions.⁴⁷ It is much easier to create a coalition between employees and management when enterprise-specific unions, rather than industry-wide unions, are present.⁴⁸

Another distinction between the labor union systems in both countries is the difference between the US’s exclusive unionism and Japan’s plural unionism. While it is the case that in the US a union is considered the “exclusive representative” for the “appropriate bargaining unit,” multiple unions may represent workers from a single class within a single workplace in Japan.⁴⁹

If we compare the relative bargaining power of employees and management in the US and Japan, Japanese labor law appears to give Japanese unions greater bargaining power than US labor law gives to

⁴⁶ See OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* 26–27 (1995).

⁴⁷ See Nobuhiro Hiwatari, *Employment Practice and Enterprise Unionism in Japan*, in *EMPLOYEES AND CORPORATE GOVERNANCE* 275 (Margaret M. Blair & Mark J. Roe eds, 1999); Dau-Schmidt & Ellis, *supra* note 15.

⁴⁸ While Japanese enterprise unions share basic interests with management, American industry unions do not generally share a strong common interest with any particular employers. See Dau-Schmidt & Ellis, *supra* note 15.

⁴⁹ “[T]he doctrine of exclusive representation probably undermines the bargaining power of American unions in the early stages of labor organization in a region or industry, although it may enhance union bargaining power for well-established unions.” *Id.*

US unions;⁵⁰ US management can therefore impose greater costs on their employees for refusing to agree to management's proposals and thus exert greater bargaining power, relative to Japanese management.⁵¹ However, the adversarial nature of negotiations in the US favors union power, while the structure of negotiations in Japan limits the desire of Japanese employees to exercise their legal rights. Such differences in the structure of negotiations between employees and management can be considered a result of the existence of different incentive patterns in the two countries.⁵²

Questions relating to which set of legal rules for renegotiation is more flexible, and whether Japanese wages are more flexible than US wages,⁵³ are hard to answer. In both countries, the law permits unilateral changes to employment contracts by management in cases of deadlock after a proper bargaining process, if no collective agreement is reached.⁵⁴ In practice, however, flexibility is more essential to management in Japan, which has strong employment protection, than in the US, which follows employment-at-will. The relatively large percentage of incentive pay, called a bonus, in employees' wages is a managerial effort to maintain wage flexibility in Japan. In both countries, the questions of which

⁵⁰ Partial work stoppage, slowdowns, and secondary boycotts are justifiable in Japan. Whereas American management can permanently replace economic strikers and undertake offensive lockouts in advance of employees collective action. *See id.*

⁵¹ *See id.*

⁵² "American management is strongly allied with the interests of shareholders," and "Japanese management is more likely to identify their interests with those of their employees." *Id.*

⁵³ *See* Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508, 512 (1999).

⁵⁴ Japanese labor law states that wages can be decreased as long as the change is reasonable (Labor Contract Act Articles 9 and 10), and case law considers the renegotiation process with labor unions as a criterion of such reasonableness, which does not resolve the resultant ambiguity. *See* Masato Hara, *Rodo Joken Henkoji niokeru Jugyoin-Keieisha kan Kosho no Igi* [*The Significance of Bargaining between Employees and Management in Determining the Fairness of Modified Labor Agreements*] in "KIGYO-HO" KAIKAKU NO RONRI: INSENTHIBU SHISUTEMU NO SEIDO SEKKEI [THE LOGIC OF "ENTERPRISE LAW" REFORMATIONS: INSTITUTIONAL DESIGN OF THE INCENTIVE SYSTEM]102 (Zenichi Shishido ed., 2011). From the economics point of view, however, strategic ambiguity may produce positive effects and prevention of disputes is not necessarily efficient. *See* Hideshi Itoh, *Kosho niokeru Kachi no Soshutsu-Bunpai to Hoseido no Hokansei* [*Value Creation and Allocation by Bargaining and Complementarities of Law*], in THE LOGIC OF "ENTERPRISE LAW" REFORMATIONS, at 132, 134.

organization should represent the diverse interests of employees and how to provide optimal rules for efficient incentive bargaining in renegotiations between employees and management are difficult to answer.⁵⁵

I.4 INCENTIVE BARGAIN BETWEEN CREDITORS AND MANAGEMENT

I.4.1 Creditors as Monetary Capital Providers

Creditors share common interests with shareholders as monetary capital providers and demand that human capital providers be monitored, particularly management. In that sense, creditors and shareholders form into a continuum rather than two distinct sets. Their conflicting interests, however, come from the fact that creditors are fixed claimants and shareholders are residual claimants. As a result, creditors prefer risk-averse management and shareholders prefer risk-neutral management.⁵⁶

Creditors have their own control rights. On one hand, creditors have a contingent right to remove assets and possibly to initiate liquidation proceedings in the event that a borrower corporation defaults, an operation which requires active monitoring. On the other hand, creditors control the borrower's access to capital in two ways. First is the periodic repayments made to the creditor which effectively reduce the cash available for use by the borrower. Second is the priority of debt claims, which can impede the borrower's future ability to raise capital from outside investors.⁵⁷ Although in general creditors have no vote for so long as the corporation is solvent, major creditors, typically banks, will have a voice and play an important monitoring role.⁵⁸

⁵⁵ See Hara, *supra* note 54, at 110.

⁵⁶ Shareholders even prefer risk-seeking management in near insolvency situations.

⁵⁷ See George Triantis, Chapter 5 in this volume.

⁵⁸ A typical example is the main bank system, or the relationship banking system in Japan in its heyday (1960s–1970s). Main banks played an important role in monitoring the management of their client companies in a contingent way. Although main banks did not intervene in the management of well-performing clients, they dispatched representatives to troubled clients, and on occasion took control of restructuring efforts. See Arikawa & Miyajima, *supra* note 21, at 51. A good example is the main bank role played by Sumitomo Bank in the case of the Mazda turnaround in the middle of the 1970s. See Richard Pascale & Thomas P. Rohlen, *The Mazda Turnaround*, 9 J. JAPANESE STUD. 219 (1983). *But see* Miwa & Ramseyer, *supra* note 21. After financial deregulation and the banking crisis in the

Although the active role of a creditor in corporate governance depends on the creditor's incentives (which rest on its economic interests in the corporation), the recent increase in the use of risk-spreading instruments, such as credit default swaps and securitization, make it easy for creditors to diversify and transfer the economic risk of their investment in corporate borrowers. The incentive of creditors may be so distorted by hedging that it results in negative exposure, leading the creditor to prefer a borrower's failure over its success.⁵⁹ This is a major challenge posed to lawmakers by financial engineering, in line with "empty voting,"⁶⁰ an issue that may require a reconsideration in regard to what corporate governance structure is appropriate.

I.4.2 Contracts, Laws, and Taking Risks

The risk-taking of management is relevant to the incentives of the other three players in the incentive bargain, particularly shareholders and creditors. Creditors have an incentive to push management to adopt a risk-averse management policy, while shareholders have an incentive to push management to adopt a risk-neutral management policy. Management is put in a position of balancing such conflicting interests.⁶¹ In this we can observe the interrelationship between the two bargaining relationships. Several contracts and laws interrelationally affect the risk-taking of management.

Creditors, particularly banks and bondholders, who feel exposed to the risk of opportunistic behavior by shareholders and management, often try to insert covenants in lending contracts to prevent management from taking too much risk, such as restrictions on providing collateral, requirements to maintain a certain level of profitability, requirements to retain certain amounts of equity or certain equity ratios, restrictions on dividends, and so on.

Besides including restrictive provisions in such contracts, several different laws encourage management to take less risk. Robust disclosure

late 1990s, the main bank system has grown more heterogeneous. Although main banks became less important to those firms with bond ratings of single A or higher, other firms continued to depend on bank borrowing. A statistical study shows that main bank commitments imposed soft-budget constraints on firms with poor performance. *See* Arikawa & Miyajima, *supra* note 21, at 75.

⁵⁹ *See* Triantis, *supra* note 57.

⁶⁰ *See infra* note 143.

⁶¹ While the role that balances conflicting interests appears to have shifted from the CEO to independent directors in the US, the role is still played by the CEO in Japan. *See infra* notes 97–98 and their accompanying text.

regulations, such as the Sarbanes–Oxley Act of 2002 (SOX) and the Financial Instruments and Exchange Act of 2006 (J-SOX),⁶² contrary to the original intention of the lawmakers, may lead management to be overly risk-averse.⁶³ Comparatively, Japanese corporate law has stricter dividend restrictions than most jurisdictions in the US.⁶⁴ Japanese corporate law also has a unique statute providing for director responsibility to third parties, who are mostly creditors.⁶⁵ Members of management at Japanese companies are at risk of being held personally liable to creditors in cases of corporate bankruptcy as Japanese bankruptcy law has procedural statutes to enforce liability against the management of a company.⁶⁶ The structure of shareholder derivative actions will also affect the risk preference of management. Japanese corporate law has no rule which allows courts to respect a board decision, which is contrary to a shareholder derivative action.⁶⁷ These aspects of Japanese law lead management to take less risk, relative to management at a US company.

On the other hand, both in Japan and in the US, tax laws that let companies deduct interest payments from their profits lead management to take more risk.⁶⁸ This is in addition to bankruptcy laws that favor the debtor-in-possession and allow management more room for renegotiation, which also leads management to take more risk.

1.4.3 Insolvency and Bankruptcy Regime

Theoretically, once insolvency has occurred, the corporate law regime ceases to be relevant and the bankruptcy law regime becomes relevant. Creditors become new residual claimants and have a vote, instead of shareholders. It is the end-game norm, which is a source of the monitoring effect of debt. After this point, all four players formally participate

⁶² On SOX and J-SOX, *see* Zenichi Shishido & Sadakazu Osaki, Chapter 20 in this volume.

⁶³ *See infra* notes 169–171 and their accompanying text.

⁶⁴ In Japan, however, shareholders can propose that a firm pays more dividends and/or repurchases shares at shareholder meetings (Companies Act Articles 454, 156). This practice is impossible in the United States. This part of Japanese corporate law therefore gives shareholders more bargaining power to push management to take more risk.

⁶⁵ Companies Act Article 429.

⁶⁶ Bankruptcy Act Articles 177, 178.

⁶⁷ In the United States, *see* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, §§ 7.08, 7.09, 7.10 (1992).

⁶⁸ *See* Gamage & Rana, *supra* note 16.

in the new incentive bargain under the umbrella of the bankruptcy law regime.

The problem is, however, the ambiguity in determining when insolvency exists; practically speaking, it is not easy to identify when a company is insolvent. Although insolvency should in theory be a definite boundary in respect of the autonomy of management, its ambiguity allows management room for renegotiation and incentivizes management to misrepresent the actual financial situation of the corporation.

I.4.4 Renegotiations under the Shadow of Law

The scope for renegotiation in the insolvency stage of a corporation depends on the type of creditors and the type of insolvency resolution systems that apply. Management can renegotiate with banks and long-term trading partners for postponement of payments of interest and/or principal, and sometimes even for a decrease in the amount of principal outstanding, particularly when creditors have committed a lot to the borrower corporation,⁶⁹ and therefore have an incentive to make short-term sacrifices in exchange for future benefits from the corporation, as long as its rehabilitation is possible. On the other hand, it is very hard for management to renegotiate with bondholders and promissory note holders, who are typically anonymous, in cases of default or potential default.

Retirees are a special type of creditor with whom renegotiation in the insolvency stage can be difficult. Renegotiations for the reduction of a company's payment obligations, which normally take the form of healthcare benefits in the US and defined benefit pension plans in Japan, is a bargain made under the shadow of laws relating to the priority of the claims of the retirees in the bankruptcy procedure and the modification of those claims.⁷⁰ Although more flexible legal rules allowing for unilateral

⁶⁹ Japanese banks have an incentive to continue making credit available even to weak corporations because it is in the self-interest of troubled banks to follow a policy of forbearance in order to avoid pressure on them to increase their own loan-loss reserves, and the government also has an incentive to allow banks to continue their forbearance policy. See Joe Peek and Eric S. Rosengren, *Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan*, 95 AM. ECON. REV. 1144 (2005).

⁷⁰ See e.g., William J. Holstein, *Who's to Blame for GM's Bankruptcy?*, Bloomberg Businessweek (June 1, 2009), http://www.businessweek.com/lifestyle/content/jun2009/bw2009061_332081.htm; The Bankruptcy of General Motors: A Giant Falls, *The Economist* (June 4, 2009), http://www.economist.com/node/13782942?fsrc=scn/tw_ec/a_giant_falls; Chikafumi Hodo, *Japan Airlines Survival Hinges on Pension Cuts*, Reuters.Com (Nov. 6, 2009), <http://www.reuters.com>.

modification of these claims and/or the downgrading of their priority will make it easier to get a compromise from the retirees and may lead to a successful reorganization, such legal rules have unfavorable effects on the *ex ante* incentive of employees.⁷¹

Management is normally able to choose between several systems of insolvency resolution. In most cases, management first attempts private reorganization in order to avoid reputational damage to the corporation. Although renegotiation in the private reorganization scenario is more flexible than that in legal reorganizations, management must obtain agreement from all creditors in order to proceed. If private reorganization is not successful, the corporation is forced to initiate legal reorganization proceedings. In this sense, even private reorganizations are proceedings conducted under the shadow of law.

The legal rules relating to reorganizations affect the incentives of the players and their relative bargaining power. Strict legal rules give management an incentive to avoid legal reorganization and, as such, interested parties may lose the opportunity to restore the value of the company. Traditional strict rules relating to legal reorganizations in Japan have opened the door to various types of private reorganization.⁷² On the other hand, flexible rules for legal reorganizations strengthen management's bargaining power against creditors.

1.4.5 Principles of Legal Reorganizations

Legal reorganizations, such as reorganizations under "Chapter 11" in the US, are schemes designed to allow for the sharing of the rights to the future going-concern value of the borrower corporation after the reorganization among the players (interested parties), without liquidating the corporation's assets. Amending the original rights of most players is requisite because the corporate value after reorganization is usually less than the sum of the original rights. The requirements for confirming a reorganization plan are based on several principles, including liquidation

com/article/2009/11/06/us-jal-pension-idUSTRE5A517U20091106; *Japan Airlines Files for Bankruptcy*, New York Times (Jan. 19, 2010), http://dealbook.nytimes.com/2010/01/19/japan-airlines-set-to-file-for-bankruptcy/?_r=0.

⁷¹ See Gen Goto, Chapter 8 in this volume. This is a typical issue for management that shows the overlap between the incentive to bargain with employees and that with creditors.

⁷² See Kentaro Suzuki, *DIP-gata Kaisha Kosei to Jigyo Saisei ADR [Debtor-in-Possession Type Reorganization and Business Rehabilitation ADR]*, in *THE LOGIC OF "ENTERPRISE LAW" REFORMATIONS*, *supra* note 54, at 176.

value guarantee, equal among same rights, and fair and equitable differences among different rights.

Although the basic scheme for legal reorganizations mentioned above is the same in the US and Japan, interpretation of the third principle – that is, “fair and equitable differences” – is not necessarily shared by both countries. While the absolute priority theory is established in the US, the relative priority theory is influential in Japan.⁷³ While the absolute priority system does not allow for distribution to lower seniority claims, unless more senior claims are fully satisfied from the going-concern value of the corporation, the relative priority system allows some distribution to lower class claims, even though upper class claims may be subject to a deduction, provided that the deduction rate applicable to the less senior claims is larger than that applied to more senior claims.

I.4.6 Deviations from Absolute Priority

It is not easy to adhere to the absolute priority rule, even in the US. In practice, valuing the future going-concern value of the corporation, which is indispensable in applying the rule, is costly and difficult. To avoid the cost, an exemption to the absolute priority rule is permitted as long as the plan is ratified by all classes upon the legally required majority votes and only the liquidation value needs to be guaranteed.⁷⁴

Incentive effects of deviations from the absolute priority rule are controversial. Although the deviation may not only distort the *ex ante* incentive of creditors and lead to an increase in interest rates, but may also induce some moral hazard for management, deviation may nonetheless have some positive incentive effects. First, relaxing the absolute priority of creditors over shareholders may give shareholders an incentive to make firm-specific human capital investments.⁷⁵ Second, relaxing the absolute priority of secured creditors over unsecured creditors may give secured creditors the incentive to monitor management more closely.⁷⁶

⁷³ See Keiko Yamamoto, *Saikosho niyoru Kigyō no Saiken: Kaisha Kosei Tetsuzuki niokeru Saikenshakan no “Kosei-Kohei” na Kenri Bumpai no Arikata wo Fumaete* [Restructuring of Companies by Renegotiation: “Fair and Equitable” Sharing of Interest among Creditors in Corporate Reorganization Procedure], in THE LOGIC OF “ENTERPRISE LAW” REFORMATIONS, *supra* note 54, at 159.

⁷⁴ 11 U.S.C. §1129(a)(8).

⁷⁵ See Lucian A. Bebchuk & Randal Picker, *Bankruptcy Rules, Management Entrenchment, and Firm Specific Human Capital* (Working Paper 1993).

⁷⁶ See Lucian A. Bebchuk & Jesse Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L. J. 857 (1996).

A recent statistical study shows, however, that few reorganization plans deviate from the absolute priority rule and senior creditor control is pervasive in Chapter 11 proceedings.⁷⁷ The same study points out that the bargain between secured and unsecured creditors can distort the reorganization process.⁷⁸

I.4.7 Renegotiation with Secured Creditors

Secured creditors may be able to hold up the bargaining process by using their right of foreclosure as a threat to obtain some share of the going-concern surplus. Both US and Japanese bankruptcy laws provide debtors with an “exit option” from such costly negotiations with secured creditors by recapturing the collateral, but in a different manner. In the US, the Chapter 11 procedure known as “cramdown” permits debtors to make deferred cash payments with a present value equal to the collateral, and the court has to estimate not only the value of the collateral but also the value of the deferred cash payments promised in the plan, a process which is complicated and time-consuming. In Japan, the Civil Rehabilitation Act procedure for extinguishing security interests permits debtors to cancel security interests by making a one-time cash payment equal to the liquidation value of the collateral; this involves a court appraisal procedure which is much simpler than in the US cramdown procedure.⁷⁹

I.5 INCENTIVE BARGAIN BETWEEN SHAREHOLDERS AND MANAGEMENT

I.5.1 Shareholders as Monetary Capital Providers

Shareholders share a basic interest with creditors as both are monetary capital providers. The method of providing money used by shareholders is, however, different from that of creditors. Shareholders have residual claims, which are not legally enforceable, but they do have voting rights and certain minority protections.⁸⁰ Therefore, the way shareholders monitor management is also different from the way creditors monitor management. Shareholders prefer risk-neutral management and have an

⁷⁷ See Kenneth M. Ayotte & Edward R. Morrison, Chapter 6 in this volume.

⁷⁸ See *id.*

⁷⁹ See Wataru Tanaka, Chapter 7 in this volume.

⁸⁰ Most *ex post* bargaining power of shareholders with management is created by corporate law.

interest in free cash flow being distributed as dividends.⁸¹ They monitor management by exit (selling stock) and voice (voting, proposing, and litigating). The latter form of monitoring has recently turned out to be important as “shareholder activism,” and is increasingly exerted to influence management.⁸²

I.5.2 Relative Bargaining Power and Laws

Although it is reasonable for shareholders to monitor management either by exit or by voice to maximize their interest, overly aggressive monitoring will distort the incentive of management. From the view of the incentive bargain, a good balance between the autonomy of management and monitoring by shareholders is important for maximizing corporate value.⁸³ Laws significantly affect the relative bargaining power of shareholders and management.⁸⁴

Voting rights and the stock majority rule

The strength of shareholders’ bargaining power with management is based on their voting rights because aggregate voting rights can be used to veto an important proposal from management, such as a mergers and acquisitions (M&A) transaction, and could even replace incumbent management if their aggregated voting rights amount to an overall majority. Although this basic rule is shared among most major jurisdictions, legal rules regarding the decision-making power of the shareholders in shareholder meetings, shareholders’ rights to elect directors, and shareholders’ rights to dismiss directors are different, particularly between the US and most other major jurisdictions including Japan. These differences affect the relative bargaining power between management and shareholders.⁸⁵

On the opposite side, however, the stock majority rule supports

⁸¹ Shareholders even have an incentive to push management to gamble with regard to the cost of creditors in near insolvency.

⁸² See Sanford M. Jacoby, *Convergence by Design: The Case of CalPERS in Japan*, 55 AM. J. COMP. L. 239 (2007); Takaya Seki, *Legal Reform and Shareholder Activism by Institutional Investors in Japan*, 13-3 CORP. GOVERNANCE 377 (2005).

⁸³ See *supra* note 6 and its accompanying text.

⁸⁴ In general, the relative bargaining power will affect the incentive of each player by either increasing or decreasing risk. The relative bargaining power between shareholders and management, in particular, directly affects the balance of autonomy and monitoring.

⁸⁵ The US adopts as the default a plurality standard for director appointment. In most major jurisdictions other than the US, proxy access is granted to dissenters’ nominees, and shareholders are granted the irrevocable right to dismiss

management control. If the stock ownership of a corporation is dispersed and no single shareholder owns a significant block, the incumbent management position is quite stable, a situation that is also supported by the proxy machinery.⁸⁶

Takeover bid (TOB) regulations, particularly the rule that requires mandatory bids for all stocks, can discourage hostile takeovers by increasing the associated costs. Reporting requirements for those holding a large volume of stocks (the so-called 5 percent rule⁸⁷) not only discourage institutional investors from acquiring stock over the threshold amount, but also discourage shareholder activism,⁸⁸ by raising the risk of misrepresentation to possible criminal sanctions.⁸⁹ Case law, which allows management to use certain defensive measures, also discourages hostile takeovers.⁹⁰

directors without cause, and the irrevocable right to initiate a shareholder meeting. See Takaaki Eguchi, Chapter 10 in this volume.

⁸⁶ See BERLE & MEANS, *supra* note 13; MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 97 (1976).

⁸⁷ This 5 percent rule was implemented as an early-warning system, in order to prevent the so-called “Saturday night special” and to promote auctions and increase takeover premiums. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 193 (10th ed, 2007).

⁸⁸ The reporting obligations for joint ownership (Financial Instruments and Exchange Act Article 27-23 (4) (5)) weaken the incentive of institutional investors to solicit other institutional investors against voting. The disclosure obligation of the purpose of holding shares (Financial Instruments and Exchange Act Article 27-23 (1)) will discourage institutional investors from making informal proposals to management. See Sadakazu Osaki, *Tairyō Hoyū Houkoku-seido no Haseikoka to Kinofuzen [Spillover Effects and Malfunction of the Large Stockholding Report Regulation]*, in *THE LOGIC OF “ENTERPRISE LAW” REFORMATIONS*, *supra* note 54, at 272.

⁸⁹ In the United States, the proxy solicitation rule and the 5 percent rule (Rule 13D) have complementarily discouraged shareholder activism. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). American law makers, however, reformed the proxy solicitation rule in 1992 and in 1999, and the 5 percent rule in 1998 to get rid of such negative effects on shareholder activism. See Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, Summer 2007 J. CORP. L. 681, 686–694. *But see* Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J. L. ECON. & ORG. 233 (2000); STEPHEN M. BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* 208 (2012) (explaining that even after the SEC’s 1992 reforms, the proxy rules still impede shareholder communication).

⁹⁰ On comparing the case law in the US and Japan, see *infra* notes 144–147 and their accompanying text.

Fiduciary duty of management

The fiduciary duty of management to shareholders⁹¹ and its private enforcement mechanism – that is, shareholder derivative and class actions – strengthens shareholders' bargaining power against management. On the other hand, the business judgment rule supports the autonomy of management by guaranteeing management discretion provided there are neither conflicts of interest nor bad faith behavior.⁹²

Board systems

Indirect ways for shareholders to monitor management, via delegated monitors such as independent directors,⁹³ play a more significant role than direct monitoring by shareholders, such as voting and litigation, under normal circumstances.⁹⁴ Therefore, the method of regulating such monitors and the board of directors affects the relative bargaining power between shareholders and management.

Strong requirements relating to independence, and the majority independent director requirement, strengthen shareholders' bargaining power against management in general,⁹⁵ and at the same time provide management with a set of legal protections against hostile takeovers and shareholder litigation in the US, but not in Japan.⁹⁶

⁹¹ Although Japanese corporate law statute stipulates “fiduciary duty to the company” (Companies Act Article 355), it is generally interpreted by leading commentators and recent court cases as “duty to the shareholder.” See MISAO TATSUTA, *KAISHA HO TAIYO* [BUSINESS CORPORATION LAW] 74 (2007); KENJIRO EGASHIRA, *KABUSIKI KAISHA HO* [LAWS OF STOCK CORPORATIONS] 20 (4th ed. 2011); *In re Nireko*, 1219 KINHAN 8 (Tokyo High Ct., June 15, 2007); *In re Rex Holdings Shareholder Litigation*, 1363 KINHAN 48 (Tokyo District Ct., Feb. 18, 2011). On the other hand, many states in the US, not including Delaware, have so-called “stakeholder statutes” that allow management to balance the interests of stakeholders, particularly in the case of a hostile takeover. See Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS.LAW. 429 (1998). See also Kitagawa, *supra* note 42.

⁹² See J. MARK RAMSEYER, *BUSINESS ORGANIZATION*, Ch. 4 (2012).

⁹³ Additionally, in Japan, statutory auditors (*kansayaku*) may play the role of “incomplete substitute” to independent directors. See Kenichi Osugi, Chapter 14 in this volume.

⁹⁴ In other words, it is not in an end-game scenario, such as a hostile takeover or bankruptcy.

⁹⁵ In the US, in particular, independent directors occupy the majority of the boards of most listed companies and often vote to replace management who have failed. See Jeffrey Gordon, *The Rise of Independent Directors in the United States*, 59 STAN. L. REV. 1465 (2007).

⁹⁶ Such difference, whether privileging the decision of independent directors or

The board system, which serves as a method for sharing the role of managing the firm between executives and monitors, is totally different in the US and Japan. In the US, the power and the role of monitors – that is, independent directors – has been steadily increasing for several decades⁹⁷ and it now seems that the role of balancing the interests of the other three players is not being played so much by CEOs, but instead by independent directors. In Japan, the power and the role of monitors, including statutory auditors and independent directors, is still limited,⁹⁸ and the CEO and inside directors still hold the real decision-making power and balance the interests of the other three players.

Minority shareholder rights

Although there are a variety of minority shareholder rights, most of them do not have an impact on shareholder bargaining power.⁹⁹ Among them, the minority shareholders' right of proposal¹⁰⁰ may be important and appears to be complementary with the decision-making power of shareholder meetings,¹⁰¹ the proxy voting system,¹⁰² and the practice of

not, creates different legal incentives for adopting independent directors in the US and Japan. See Curtis J. Milhaupt, Chapter 9 in this volume.

⁹⁷ See Gordon, *supra* note 95.

⁹⁸ The major reasons that there are so few outside directors in Japan are the lack of well-developed external labor markets and the robust “company community” social norm. See Osugi, *supra* note 93.

⁹⁹ Although a series of studies by La Porta et al. see minority shareholders' rights as the key to an efficient capital market (Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer, & Robert W. Vishny, *Legal Determinants and External Finance*, 52 J. FIN. 1131 (1997)), few of them have any substantial effect on strengthening shareholder bargaining power with management. See John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control*, 111 YALE L. J. 1, 8 (2001). See also Sofie Cools, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697 (2005); Holger Spamann, *The “Antidirector Rights Index” Revisited*, 23 REV. FIN. STUD. 467 (2010).

¹⁰⁰ See Companies Act Articles 303, 304, 305. In Japan, shareholders can propose amendments to the articles of incorporation without board approval, while this is impossible in the US. See BAINBRIDGE, *supra* note 89, at 204.

¹⁰¹ In Japan, the shareholder meeting is able to make decisions on a wider range of matters than the US shareholder meeting, such as dividends, repurchase of shares, and directors' salaries. In 2011, a non-binding vote on executive compensation (“say on pay”) was given to shareholders of listed companies by the Dodd–Frank Act in the US (Securities Exchange Act §14A).

¹⁰² Whether proxy access is granted or not, and whether coalition-forming among institutional investors is admitted or not, are particularly influential.

shareholder activism by institutional investors.¹⁰³ Appraisal rights in cases of M&A transactions may also be influential, depending on the case law relating to fair value, and may work to discourage M&A transactions.¹⁰⁴

Disclosure regulations and information rights

Information asymmetry is the biggest barrier to shareholders' monitoring of management.¹⁰⁵ Stronger disclosure regulations strengthen shareholder bargaining power. Disclosure regulations that are too strong will, however, distort management's incentives to take adequate risk, increase managerial compensation, and may even give management an incentive to manipulate information.¹⁰⁶

Shareholders' information rights to inspect books and records, as well as to obtain the shareholders' list are valuable adjuncts to enforce fiduciary duties in litigation or proxy fights. Apart from shareholders' information rights provided by corporate law and securities regulation, the strong pre-trial discovery system, complementarily with a system that allows for wide range of injunctive relief, strengthens shareholder bargaining power with management in the US.¹⁰⁷

I.5.3 Legal Liabilities of Management and Shareholder Suits

The legal liability of management is a major restriction on the autonomy of management in addition to the possibility of hostile takeovers as a market restriction. Management, both directors and officers, owe fiduciary duties

¹⁰³ See ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 411 (2nd ed 2011).

¹⁰⁴ In the US, besides the appraisal remedy and fiduciary fairness actions (which provide the same measure of damages as appraisal), injunctive relief accompanied by shareholder suits based on a violation of directors' fiduciary duty plays an important role. The appraisal system and the injunction system may have different deterrent effects depending on the court's valuation of company stock. If courts create the public impression that they tend to overvalue a target's shares, the appraisal system will have a substantial deterrent effect on takeovers. On the other hand, although the injunction system does not have such a general deterrent effect, it may individually frustrate efficient corporate takeovers if the realized value of the court's valuation exceeds the target's potential enterprise value. See Akio Hoshi, Chapter 13 in this volume.

¹⁰⁵ Besides the problem with information asymmetry, the "rational apathy" and "collective action" problems are other barriers to effective monitoring by shareholders.

¹⁰⁶ See Hermalin, *supra* note 6.

¹⁰⁷ The weak discovery system in Japan discourages the use of injunctions against management activities (Companies Act Articles 360, 422) and the raising of shareholder derivative actions.

to shareholders, which consist of the duty of loyalty and the duty of care.¹⁰⁸ If management breach their duties, they will owe legal liability in respect of the resulting damage to the corporation and shareholders. Accordingly, the shareholder derivative and representative class actions play an important role as an enforcement mechanism. In Japan, although there is no class action system yet, a part of the US's shareholder direct actions is covered by Japan's unique corporate law statute providing for director responsibility to third parties (so called "Article 429 actions").

As an enforcement scheme in respect of legal liabilities of management, however, the shareholder derivative action has a serious problem with its incentive structure. There is no monetary incentive for the plaintiff shareholder,¹⁰⁹ who may be a minimum-amount holder, to raise a derivative action that will have a strong impact on management which is disproportionate to the amount of their residual claim.¹¹⁰

The risk of having to pay damages from their own pockets, which is determined by both substantive rules (including directors' and officers' – D&O – insurance contracts) and enforcement mechanisms, affects the incentive of management and monitors.¹¹¹ It is important but not easy to maintain a sufficient deterrent effect while avoiding too much of a chilling effect on management.¹¹²

¹⁰⁸ While US case law distinguishes the duty of loyalty and the duty of care from a conflict-of-interest point of view, Japanese case law denies such a distinction and takes the fiduciary duty as a whole. See Hideki Kanda and Curtis J. Milhaupt, *Re-examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law*, 51 AM. J. COMP. L. 887 (2003).

¹⁰⁹ Plaintiff attorneys have an incentive to organize shareholder derivative actions because of the ability to collect under the contingency fee system in the US. Although in Japan the fee system does not give attorneys enough monetary incentive, they receive gains in the form of advertising, rewarding work, or altruistic gains; derivative litigations occur with relative frequency even without the same level of monetary incentives seen in the US. See Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. L. STUD. 351 (2001).

¹¹⁰ That is also the rationale for the use of class rather than individual shareholder action. Some commentators argue that even purely irrational behavior has played more than a marginal role in driving shareholder litigation in Japan. See Dan W. Puchniak & Masafumi Nakahigashi, *Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation*, 45 VAND. J. TRANSNAT'L L. 1 (2012).

¹¹¹ See Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991) (arguing that the risk to directors of having to pay from their own pockets is rare and the shareholder derivative action has almost no deterrent effect in the US).

¹¹² It is obvious that shareholder derivative action has been significantly affecting the incentive of management and monitors in Japan since the legisla-

In order to decrease the chilling effect from the shareholder derivative action on management, the law provides several schemes in the US and Japan. First, the business judgment rule basically prevents non-interested management and directors from being liable for their business decisions, provided they are made pursuant to adequate procedure.¹¹³ Second, the law permits corporations to set a cap on the maximum amount of damages its directors may be required to pay,¹¹⁴ in addition to permitting the purchase of D&O insurance.¹¹⁵ And third, the law provides ways of screening shareholder suits, such as the demand requirement and litigation committees in the US¹¹⁶ and security for expense awards by the court in Japan.¹¹⁷

I.5.4 Control Transactions

Hostile takeovers as a source of shareholders' monitoring power

Hostile takeovers are phenomena via which shareholders replace inefficient management who are not successful in maximizing shareholder value

tive reduction of the filing fee in 1993, which increased the number of actions dramatically, and particularly since the 2000 Daiwa Bank decision (*In re Daiwa Bank Derivative Litigation*, 1271 HANJI 3 (Tokyo District Ct. Sep. 20, 2000)), which awarded \$775 million – an award 66 times higher than the previous record (see Bruce E. Aronson, *Reconsidering the Importance of Law in Japanese Corporate Governance: Evidence from the Daiwa Bank Shareholder Derivative Case*, 36 CORNELL INT'L L. J. 11, 50 (2003–2004)), although it is arguable whether the current system provides an optimal deterrent effect or too much of a chilling effect.

¹¹³ The business judgment rule is, however, not perfectly clear even in the US (see Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993); William T. Allen, *The Corporate Director's Fiduciary Duties of Care and the Business Judgment Rule Under US Corporate Law*, in COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 307 (Klaus J. Hopt et al. eds., 1998)), and the court has been reviewing the reasonableness of management decisions in Japan (see *in re Nomura Securities Co.*, 1760 HANJI 144 (Tokyo District Ct. Jan. 25, 2001)). In addition, the business judgment rule does not necessarily protect directors that fail to exercise their duty to monitor management. See *in re Caremark Int'l Inc. Derivative Litigation*, 698 A. 2d 1156 (De. Ch. 1996); *in re Daiwa Bank*, 1721 HANJI 3 (Osaka District Ct. Sep. 20, 2003).

¹¹⁴ Neither US nor Japanese law permit an *ex ante* cap on maximum damage for executives; both permit it only for monitors, such as outside directors.

¹¹⁵ D&O insurance contracts give both defendant directors and plaintiff attorneys the incentive to settle in the US. See Romano, *supra* note 111, at 57.

¹¹⁶ See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 2010, 2011 (10th ed. 2007).

¹¹⁷ See Puchniak & Nakahigashi, *supra* note 110, at 49.

by using the resources of the corporation.¹¹⁸ Although hostile takeovers do not occur frequently, the possibility of their occurrence, in other words the existence of the market for corporate control, provides shareholders with a source of monitoring power over management.

The possibility of hostile takeovers is particularly effective at solving the agency problem related to free cash flow.¹¹⁹ How much free cash flow should be distributed to shareholders or retained in the corporation is an issue of sharing control, rather than an issue of sharing value added, between management and shareholders, because it is a matter of degree of management discretion in operating monetary capital. If a corporation retains too much free cash flow, management is not only likely to be idle as a result of escaping the monitoring effects of debt, but also likely to waste free cash flow on empire building. Stock markets will discount the value of the stock of companies with a lot of free cash flow, and the possibility of such companies facing a hostile takeover will increase. This increase in the risk of a hostile takeover exerts pressure on management to distribute free cash flow to shareholders.

There are conflicting interests between shareholders and the other three players when it comes to the choice between distributing dividends or retaining earnings. Employees and management share the same interest as human capital providers: to retain control over monetary capital. Creditors also have an interest in maintaining free cash flow in the company as it minimizes their risk in a corporate bankruptcy scenario. Such interests encourage management, employees, and creditors, including banks and trading partners, to create a coalition against shareholders who insist that the company should distribute free cash flow.¹²⁰

¹¹⁸ From an economic point of view, the hostile takeover is a scheme for efficient resource allocation and the market for corporate control enables resources to move more quickly to their highest-value use. See Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21 (1988).

¹¹⁹ See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995). See also Ronald Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L. J. 871 (1993) (pointing out that Japanese main bank monitoring, without a corporate control market, failed to monitor the use of free cash flow).

¹²⁰ On the general coalition between employees and management, see *supra* notes 27–31 and their accompanying text. Such a general coalition is strengthened by cross-shareholding and turns into an alliance against genuine shareholders in Japan. See *infra* notes 141–142 and their accompanying text.

Balancing autonomy and monitoring

The optimal level of potential for a hostile takeover is a typical issue of balancing autonomy and monitoring. Although a certain level of potential for a hostile takeover is indispensable in monitoring management, if there is too much potential it will distort the incentive of human capital providers to make firm-specific investments.

Therefore, several mechanisms have been invented to reduce shareholder ability to disrupt management, typically through staggered boards, “poison pills,” and “shark repellent” provisions in charters or bylaws in the US; and cross-shareholdings, issuing new stocks to “white squires,” and Japanese-style “poison pills” in Japan.¹²¹

Regulations of buyers and sellers

Most countries with a market for corporate control have regulations in respect of control transactions, including both hostile and friendly takeovers, because control transactions inevitably give rise to serious conflicting interests between all players. Such regulations usually include regulations on both buyers (acquirers) and sellers (management and boards of target companies).

Regulations on buyers are basically TOB regulations and disclosure regulations applicable to large shareholders (the 5 percent rule). These regulations discourage control transactions to a certain degree.¹²² In particular, requiring mandatory bids forces controlling shareholders to share their controlling premium with minority shareholders and discourages controlling shareholders from selling their controlling blocks.¹²³ Requiring mandatory bids for all shares increases the cost of takeovers and discourages raiders from buying companies. Therefore, although strong TOB regulations may effectively protect minority shareholders, particularly against coercive bids, they support management autonomy, rather than shareholder monitoring, from the point of view of balancing autonomy and monitoring.

Regulations on sellers are basically defense regulations. Case law has been developed on how to regulate defensive measures in both the US and Japan. The difficulty of solving specific cases of takeover battles is that raiders do not necessarily maximize shareholder value, and instead may destroy corporate value, although management and the board of directors

¹²¹ Most Japanese poison pills are “pre-warning rights plans,” which lack legal effect. See Milhaupt, *supra* note 96.

¹²² See *supra* notes 87–89 and their accompanying text.

¹²³ See EASTERBROOK & FISCHER, *supra* note 14, at 109.

will not be free from conflicts of interest in implementing and exercising defensive measures.¹²⁴

It is important to consider these regulations on buyers and sellers as a whole in order to maintain a good balance between autonomy and monitoring. The UK system maintains a good balance by enforcing strong regulations on both buyers and sellers; that is, requiring buyers to make mandatory bids for all shares and by prohibiting incumbents from initiating any defense. The US system is another example of a well-struck balance, reached by putting weak regulations on both buyers and sellers; that is, not requiring buyers to make mandatory all-share bids but allowing boards to implement defenses. Japan's system follows a UK-like takeover rule and a US-like defense rule. As a result, the balance is too much in favor of management autonomy.¹²⁵

Appraisal remedy and minority protections

Control transactions may give rise not only to conflicting interests between shareholders and human capital providers, but also to conflicting interests among shareholders. In particular, minority shareholders are susceptible to economic damage. Therefore, most countries with a market for corporate control have minority shareholder protection laws, such as fiduciary duty claims and the appraisal remedy available to dissenting shareholders.¹²⁶

Historically, the appraisal remedy was developed to make mergers and other types of reorganizations possible by way of a majority vote, so that a unanimous vote was not required. As such, the appraisal remedy has basically played a role in expanding management discretion. The appraisal

¹²⁴ JESSE H. CHOPER, JOHN C. COFFEE, JR., RONALD J. GILSON, *CASES AND MATERIAL ON CORPORATIONS* 945 (7th ed. 2008).

¹²⁵ Zenichi Shishido, *A Response to John Armour, Jack B. Jacobs and Curtis J. Milhaupt*, *HARV. INT'L L. J.* (Feb. 10, 2011), http://opiniojuris.org/2011/02/10/hilj_shishido-response-to-armour-jacobs-milhaupt/.

¹²⁶ While in the US, fiduciary duty claims play a more important role than appraisal rights, the appraisal right is in practice the exclusive remedy in Japan because neither the Companies Act nor the case law stipulate the existence of directors' fiduciary duty to specific shareholders who suffer damage because of a board decision, such as damage suffered due to a merger. Certain Japanese commentators argue that for the purpose of providing a stronger incentive to management and directors to make the term of mergers more fair, fiduciary duty claims would be more effective than appraisal rights. See Hidesusa Iida & Kenichi Sekiguchi, Chapter 12 in this volume. A reason why fiduciary claims are more important than appraisal actions in the US is the collective action problem: they can take the form of representative actions, whereas appraisal cases are individual claims, and courts need not award attorney's fees.

remedy may, however, give minority shareholders an incentive for opportunistic behavior and discourage reorganizations, depending on how case law interprets the concept of “fair value.”¹²⁷

I.5.5 Cross-Shareholding and Schemes to Reduce Shareholder Disruption to Management

The mechanism and its reasoning

Each cross-shareholding is made between two companies, with each holding stock in the other company. The reasoning behind such an arrangement is to create a business alliance. Cross-shareholding may be useful to maintain a long-term trading relationship. Cross-shareholding between trading partners, typically between supplier and manufacturer, so called vertical *keiretsu*, has been positively evaluated as a mechanism to discourage opportunistic behavior by trading partners and encourage companies to make relation-specific investments.¹²⁸

Another purpose of cross-shareholding is to defend against hostile takeovers. Management of cross-shareholding partners implicitly agree to support each other in the exercise of their voting rights. Since the 1950s, defensive web-like circles of cross-shareholding have been established and maintained among the pre-war *zaibatsu* companies as loose-knit, bank-centered groups and communities of equals, so called horizontal *keiretsu*.¹²⁹ Horizontal *keiretsu* can be viewed as a mechanism by which the corporation becomes an owner of itself.¹³⁰

¹²⁷ The Companies Act of 2005 revised the original Japanese appraisal right provision that, similar to the Delaware General Corporation Law, did not include synergies arising from the merger. This revision enabled the courts to include such synergies in the stock price valued through appraisal, which may have in turn deterred certain mergers from occurring. Other important differences between the Japanese appraisal remedy and its American counterpart are the reliance of the Japanese courts on the market price to determine the appraisal price and the lack of any exception, such as the “market out” exception, in granting appraisal rights in Japan. See Iida & Sekiguchi, *supra* note 126. See also Hoshi, *supra* note 104.

¹²⁸ See Gilson & Roe, *supra* note 119, at 886, 891–895.

¹²⁹ See James R. Lincoln & Masahiro Shimotani, Whither the Keiretsu, Japan’s Business Network: How Were They Structured? What Did They Do? Why Are They Gone? (Working Paper 2009). *But see* Yoshiro Miwa & Mark Ramseyer, *The Fable of Keiretsu*, 11 J. ECON. & MGMT. STRATEGY 169 (2002).

¹³⁰ See Eguchi, *supra* note 85.

The unwinding and reconstructing of cross-shareholding

Following the financial crisis of 1997, the rate of cross-shareholding, particularly bank ownership, steadily decreased until 2004. Banks reduced their shareholdings mainly by selling those shares with higher liquidity and higher expected rates of return, while holding on to the shares of those firms with which they had long-term relationships. Such investment behavior not only undermined the corporate governance of their portfolio companies, but also led to the degradation of their own portfolios.¹³¹

From the point of view of cross-shareholding, one can observe heterogeneity among Japanese listed companies. Profitable companies with easy access to capital markets and a high percentage of foreign ownership have tended to unwind their cross-shareholdings, while low-profit companies without easy access to capital markets and a low percentage of foreign ownership have tended to keep their cross-shareholding relationships with banks in place.¹³²

Cross-shareholding has even started to increase among the latter type of companies since 2005, the year the market for corporate control in Japan opened.¹³³ It would therefore seem that the benefit of cross-shareholding to the management of companies that are subject to a high risk of takeover must be larger than the risk of a bad reputation in the stock market.

The cost of cross-shareholding

Beyond the business logic of maintaining long-term trading relationships, the defense purpose of cross-shareholding should not be evaluated only in a negative light. In every country, some scheme to reduce shareholder disruption to management is indispensable in order to balance management autonomy and shareholder monitoring.¹³⁴ In the US, corporate law follows the principle of director primacy and restricts the decision-making power of shareholder meetings, and case law has allowed certain “poison

¹³¹ See Hideakai Miyajima and Fumiaki Kuroki, *The Unwinding of Cross-Shareholding in Japan: Causes, Effects, and Implications*, in CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY 79 (Masahiko Aoki et al. eds, 2007).

¹³² See *id.* For a discussion of a new pattern of management-shareholders relation and a possible role for institutional investors, see Zenichi Shishido & Takaaki Eguchi, *The Future of Japanese Corporate Governance: Internal Governance and the Development of Japanese-Style External Governance through Engagement*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER (Randall Thomas & Jennifer Hill eds., forthcoming).

¹³³ See *id.*

¹³⁴ See Eguchi, *supra* note 85.

pill” to stand as defenses.¹³⁵ In the UK, although corporate law respects shareholder choice as it does in Japan, shareholder intervention occurs mainly through collective engagement by major domestic investment managers who have historically formed a close-knit community.¹³⁶ Cross-shareholdings have played a major role in reducing shareholder ability to disrupt management in Japan.

The problem is that the cost of cross-shareholding often turns out to be too high. This cost is twofold: first is the cost of implementing and maintaining the scheme, and second is the cost of entrenchment.

The first cost of cross-shareholding, which will accrue to shareholders, is higher than that of a poison pill, particularly when stock prices decrease. Such a cost could theoretically function as soft market monitoring: if cross-shareholding partners sell off underperforming stock that they cannot tolerate to hold, the underperforming company may become the target of hostile takeovers. The reality is that after the financial crisis in 1997, however, the opposite occurred, as previously noted.¹³⁷

The second cost, that associated with the entrenchment of cross-shareholding, has only become obvious with the passage of time. After the control market was created and the trend of shareholder activism emerged in 2005, the management of listed companies vulnerable to hostile takeovers started to re-establish cross-shareholdings, which had been decreasing during the 1990s. A statistical study shows that firms with poison pill defenses also tended to organize more cross-shareholdings. This suggests that cross-shareholdings and poison pills are not substitutive but instead are complementary, which indicates the entrenchment of management.¹³⁸

In the US, poison pills seldom block hostile bids. Independent directors, the Delaware courts, and the capital markets complementarily cause poison pills to operate largely as a negotiation tool, rather than as a means of entrenchment.¹³⁹ In Japan, the combination of cross-shareholdings and poison pills can in fact block hostile takeovers.¹⁴⁰

In some Japanese listed companies, at least, there are conflicting inter-

¹³⁵ *See id.*

¹³⁶ On engagement in the UK, *see id.*

¹³⁷ *See supra* note 131 and its accompanying text.

¹³⁸ *See* Miho Takizawa, Kotaro Tsuru & Kaoru Hosono, Baishu Boeisaku Donyu no Doki: Keiei Hoshin Kasetu no Kensho [Takeover Defense Measures: Testing of Entrenchment Hypothesis for Corporate Managers] (RIETI Discussion Paper, 2007).

¹³⁹ *See* Ronald J. Gilson, *The Poison Pill in Japan: The Missing Infrastructure*, 2004 COLUM. BUS. L. REV. 21 (2004).

¹⁴⁰ *See Steel Partners v. Bulldog Sauce*, 61-5 MINSHU 221 (Sup. Ct., Aug. 7, 2007).

ests between genuine shareholders who vote for maximizing shareholder value¹⁴¹ and cross-holding shareholders who vote for other purposes, such as maintaining their trading relationships; there is a possibility that as a result, the interests of genuine shareholders may be damaged. Generally speaking, if a substantial percentage of shareholders exercise their voting right in a way which does not maximize shareholder value, the preposition of corporate law, which gives voting rights exclusively to shareholders, will collapse.¹⁴² This issue is related to “empty voting.”¹⁴³

Law and cross-shareholding

Regulations affecting defense mechanisms set out in Japanese takeover law, which have been developed since 2005, encourage management to organize defensive cross-shareholdings by encouraging *ex ante* shareholder approval of defensive plans.¹⁴⁴ In particular, the Supreme Court decision in the Bulldog Sauce case in 2007,¹⁴⁵ which held that the exercise of the poison pill by Bulldog Sauce was legitimate because it was supported by a majority of the shareholders, gives management an incentive to create cross-shareholdings between companies which are vulnerable to hostile takeovers, even incentivizing the creation of inefficient business alliances as an excuse for such cross-shareholdings.¹⁴⁶ The business

¹⁴¹ Although some genuine shareholders may not exercise their voting rights because of “rational apathy,” if they vote, they will always vote for maximizing shareholder value.

¹⁴² In this regard, the reinterpretation of a Japan’s corporate law statute which prohibits the giving of a benefit in exchange for the exercise of shareholder rights (Companies Act Article 120) is suggested. Although the statute was originally made to prohibit management from bribing professional shareholders (*sokaiya*), it may be utilized for aligning the incentive structure of shareholders in the context of cross-shareholding. See Takahito Kato, Riekikyoyo Kinshi Kitei to Kabushiki Mochiai: Kabunushi no Insenthibu Kozo no Kanten kara [*Corporate Law Statute to Prohibit Giving Benefit for the Exercise of Shareholder Rights and Cross-shareholding: From the Point of View of the Shareholders’ Incentive Structure*], in THE LOGIC OF “ENTERPRISE LAW” REFORMATIONS, *supra* note 54, at 227.

¹⁴³ See Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007).

¹⁴⁴ The Takeover Guidelines of 2005 and the Bulldog Sauce case encourage acquiring shareholder approval, which is effectively required by the Tokyo Stock Exchange rules. See Milhaupt, *supra* note 96.

¹⁴⁵ *Steel Partners v. Bulldog Sauce*, 61-5 MINSHU 221 (Sup. Ct., Aug. 7, 2007). See Milhaupt, *supra* note 96.

¹⁴⁶ See Peng Xu & Wataru Tanaka, *Baishu Boeisaku in za Shado obu Mochiai: Jirei Kenkyu* [*Anti-Takeover Measures in the Shadow of Cross-Shareholding: A Case Study*], 1885 SHOJIMOMU 4 (2009).

judgment rule protects management's discretion to organize defensive cross-shareholdings, which can then serve as an excuse for creating business alliances.¹⁴⁷

On the other hand, various laws can be effective in discouraging management from establishing defensive cross-shareholdings and encouraging management to instead dissolve existing cross-shareholdings.

The Bank for International Settlements (BIS) regulation of banks' equity capital has had the effect of decreasing cross-shareholding by banks, particularly after the financial crisis of 1997.¹⁴⁸ Although the Banking Act and Anti-Monopoly Act cap bank ownership of the voting rights of a business corporation at 5 percent, this is not a meaningful deterrent against cross-shareholding. Nor is it an adequate reason for distinguishing banks' shareholdings from business corporations' shareholdings.¹⁴⁹

Mark-to-market accounting, which has applied to cross-shareholding stocks since the fiscal year beginning April 2001,¹⁵⁰ may have some effect in discouraging management from creating and maintaining cross-shareholdings. Similarly, further disclosure requirements related to cross-shareholding situations would have a disincentivizing effect on cross-shareholdings via stock market monitoring.

It is arguable whether or not strong regulation, such as denying voting rights connected to cross-shareholding stocks, is required. A milder alternative would be either to require agreement from a shareholder meeting which consists only of genuine shareholders, or allowing genuine shareholders to sue for injunctive relief upon the exercise of any voting rights by cross-holding shareholders and for the annulment of any resolutions taken at the relevant shareholder meeting.¹⁵¹

¹⁴⁷ The different approaches taken by US and Japanese takeover laws on shareholder approval provide contrasting incentive effects on the independent director system. The US takeover law, which gives the board of directors the exclusive gatekeeper role, without any participation by shareholders, generates strong incentives for boards to be comprised of truly independent directors in order to establish the reasonableness of board decisions. On the other hand, the Japanese takeover law, which focuses on shareholder approval and does not privilege the decisions of independent directors or committees, creates few incentives for the adoption of independent directors. See Milhaupt, *supra* note 96.

¹⁴⁸ Banks choosing to sell off stocks was, however, not based on performance, but on relationship with portfolio companies. See *supra* note 131 and its accompanying text.

¹⁴⁹ See Akira Tokutsu, Chapter 11 in this volume.

¹⁵⁰ Enterprise Accounting Committee, Financial Instruments Accounting Guideline of 1999.

¹⁵¹ See Kato, *supra* note 142.

I.6 ROLES OF GOVERNMENT

Government is the provider of indispensable infrastructure for business activities, both physical infrastructures and legal infrastructures. Legal infrastructure includes both legislation and public enforcement of laws.¹⁵² As compensation for these services, government levies taxes on the firm and the four players. Government is also the regulator of each industry, as the delegate of consumers. In each of these aspects, as the legislature, the enforcer of laws, the taxing authority, and the regulator of industries, the government affects nearly all aspects of the incentive bargain of the firm.

I.6.1 Taxation and Incentives

The four players provide the corporation with capital that is indispensable in running its business, either human capital or monetary capital. The corporation pays some form of compensation to all capital providers. Compensation paid to human capital providers is treated differently when it comes to corporate-level tax, depending on the identity of the payees: salary paid to employees is fully deductible as a cost, whereas salary paid to management is not fully deductible in Japan.¹⁵³ Compensation paid to monetary capital providers is treated even more differently, depending on the identity of the payees: interest paid to creditors is fully deductible as a cost, whereas dividends paid to shareholders are not deductible but instead are taxed at both the corporate level and the shareholder level, under a system known as “double taxation.”¹⁵⁴ Such differences in tax treatment may have incentive effects on management.

¹⁵² The two fundamental elements of legal infrastructure which are indispensable for making the incentive bargain of the firm efficient and developing the market economy, are those for protecting private property and for enforcing contracts. Without such elements, people’s incentive to invest and incentive to trade would be distorted. Although in most emerging economies these basic elements may not yet be in place, this chapter takes them as given in the US and Japan.

¹⁵³ Although US law also placed a limitation on tax deductions for compensation received by corporate executives, the limitation depends not on the category of human capital provider but on the amount of compensation. *See* Tetsuya Watanabe, Chapter 16 in this volume.

¹⁵⁴ Most countries have some adjustment system aimed at double taxation when the payee is a corporation. A part of dividends received is not recognized as income of the payee corporation depending on how much of the payer corporation’s stock is owned by the payee corporation. The difference of such non-recognition rules in different countries may impact corporate group planning. *See* Randal Morck, *How to Eliminate Pyramidal Business Groups: The*

Double taxation may incentivize management to choose debt financing as long as the resulting debt–equity ratio is within a reasonable level. Double taxation also encourages retained earnings,¹⁵⁵ and may facilitate managerial empire building. The cost of double taxation is not necessarily carried by shareholders, as management has an incentive to transfer the cost of corporate income tax to the player with the weakest bargaining power, which may be the employees.¹⁵⁶

Individual income tax law gives human capital providers, particularly management, an incentive to shift from taxable monetary compensation to non-taxable non-monetary compensations, such as fringe benefits, and the use of tax deferral through incentive compensation schemes.¹⁵⁷ There is no strong evidence that tax law significantly influences the substance of equity compensation – that is, the mix between equity and cash and the risk and term structure – but it is possible that tax law has had an impact on the form of equity compensation, particularly in regard to start-up companies and venture capital funds.¹⁵⁸

Another area of corporate income tax law, which significantly affects corporate behavior by influencing the incentives of management, is the non-recognition rule of corporate reorganizations. Although reorganizing transactions, such as mergers, are basically taxable because they are realization events, if the transactions are qualified reorganizations under the law, no gain or loss will be recognized at both corporate and shareholder levels, and the basis of the assets or stock transferred will be carried over. Japanese reorganization tax law, compared with the US law, is prohibitive against corporate spin-offs and encourages the creation of wholly owned subsidiaries.¹⁵⁹ It is also important to note that the record-keeping requirements of corporate income tax law may facilitate stronger corporate governance and support monetary capital providers as a result.

Double Taxation of Inter-Corporate Dividends and Other Incentive Uses of Tax Policy (Working Paper 2004). *But see* Steven A. Bank & Brian R. Cheffins, *The Corporate Pyramid Fable* (Working Paper 2011).

¹⁵⁵ The reason why the corporation pays dividends despite the cost of double taxation is usually explained by the signaling theory.

¹⁵⁶ The cost-bearer of double taxation may be trading partners or consumers, depending on the market. *See* Watanabe, *supra* note 153.

¹⁵⁷ *See* Gamage & Rana, *supra* note 16.

¹⁵⁸ *See* Mark P. Gergen, Chapter 17 in this volume.

¹⁵⁹ *See* Tetsuya Watanabe, *Tax-Free Treatment for Corporate Reorganizations in Japan* (Sho Sato Conference Paper 2009). Japanese law also provides a “continuity of employees” requirement and a “no boot” requirement for qualified reorganizations. *See id.*

1.6.2 Public Monitoring and Enforcement

The government also plays an important role in monitoring and enforcing substantive legal rules. This subsection focuses on anti-competition regulations and securities regulations, which are two typical areas where public monitoring and enforcement are indispensable for maintaining efficient markets.¹⁶⁰

Human capital providers, both management and employees, have an incentive to collude with competitors in order to avoid robust market competition. It is widely recognized that such collusions damage consumer interests and product market efficiency.¹⁶¹ Therefore, public monitoring and enforcement is indispensable when it comes to combating anti-competitive activities. Product markets with little room for collusion give management an incentive to encourage employees to produce better products at a cheaper price.

Regarding anti-competition regulations, every jurisdiction's enforcement system has its own characteristics rather than in its substantive rules. The form of sanctions under US law is criminal; it is administrative under European Union (EU) law; and a hybrid of both under Japanese law. Some commentators think that the Japanese enforcement system does not have enough of a deterrent effect because the administrative surcharge is aimed only at collecting gain, the amount is automatically calculated, and cannot reflect the culpability and gravity of the subject conduct, and imprisonment without suspension of the term has not yet occurred.¹⁶²

Securities regulations and their enforcement contribute to the efficiency of capital markets. Unfair trading regulations create capital markets with little room for insider trading and manipulation, and encourage investor participation. Disclosure regulations create capital markets which efficiently reflect accurate information.¹⁶³ The existence of an efficient capital market encourages monitoring based on the market price of stocks¹⁶⁴ and gives management an incentive to run the company's business with a view toward increasing stock price.

¹⁶⁰ See Howell E. Jackson, Chapter 18 in this volume.

¹⁶¹ See ROBERT S. PINDYCK & DANIEL L. RUBINFELD, *MICROECONOMICS* §12.7 (7th ed. 2008); PHILIP AREEDA & LOUIS KAPLOW, *ANTITRUST ANALYSIS* §201 (6th ed. 2004).

¹⁶² See Shigeki Kusunoki, *Shaping an Anti-Monopoly Law Sanction Regime Against Cartels or Bid Collusion: A Perspective on Japan's Choice*, 79 U. DET. MERCY L. REV. 399 (2001–2002).

¹⁶³ *But see infra* note 170 and its accompanying text.

¹⁶⁴ See Gordon, *supra* note 95, at 1541.

Although the substantive rules of securities regulations are not particularly different between the US, the EU, and Japan, their enforcement systems are substantially different. While *ex post* monitoring via litigation initiated by the Securities Exchange Committee and private parties has played an important role in the US,¹⁶⁵ *ex ante* monitoring by the Ministry of Finance (currently the Financial Services Agency, FSA) played the dominant role with almost no private enforcement actions in Japan until 1990.¹⁶⁶ In 1991, following several securities scandals, the Securities and Exchange Surveillance Commission (SESC) was founded and has since been active in *ex post* enforcement of securities regulation. Besides the SESC, the Tokyo Stock Exchange also plays an important role in monitoring. Private enforcement attempts still rarely occur in Japan.¹⁶⁷

I.6.3 Disclosure Regulations and SOX

Government is the major monitor and enforcer of disclosure regulations not only via securities regulation, but also via corporate law, industry regulation, and so on. Disclosure regulation is an example of an area of law that requires a good balance, which is not the general perception; that is, the stricter, the better. I will focus on the SOX law in the US as a good example of this.

The SOX law in the US constitutes governmental intervention into the internal control of listed companies and provides a good example of the way in which the government can significantly affect the incentive bargain of the corporation as a monitor and an enforcer; examining SOX also raises the legislative policy question regarding what is the optimal approach to disclosure regulation.

¹⁶⁵ Although private enforcement has the potential to offer important contributions to the robustness of a capital market, public enforcement has a more major role to play and is a necessary complement to private enforcement. See Jackson, *supra* note 160; Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207 (2009).

¹⁶⁶ Corporate cross-shareholding patterns in post-war Japan and the relative low priority traditionally placed on formal securities regulation and its enforcement are probably interrelated. See Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J. INT'L L. 423 (1994).

¹⁶⁷ A reason for the scarcity of private litigations in Japan may be the lack of a class action mechanism. The potential for collective actions through use of the internet and new legislation on no-fault liability and presumptive damage (the Financial Instruments and Exchange Act Article 21-2) may encourage private litigation in misrepresentation cases in Japan in the future.

Because the SOX law is a regulation not on the corporation itself, but on the specific players¹⁶⁸ – that is, management and auditors – and because it includes criminal sanctions among its enforcement tools, it has a significant influence on the incentive of the players, for better or worse.

Although the SOX law probably strengthens shareholder bargaining power with management in respect of better disclosure, negative side effects have also been noted. In addition to the significant increase in the cost of maintaining sufficient internal controls, the SOX law discourages management from taking risks by strengthening the bargaining power of monitors, such as auditors and independent directors.¹⁶⁹

Generally speaking, as a result of too much transparency, management is induced to behave in ways that merely look good rather than in ways that are truly good. Overly aggressive disclosure regulations may lead management to become too timid and may even lead management to manipulate information.¹⁷⁰

Four years after SOX was implemented, the Japanese legislature implemented internal control regulations similar to those that make up the SOX law, often cited as the J-SOX law. The impact of the SOX law and the J-SOX law, however, appear to be totally different. Although the J-SOX law did not successfully strengthen shareholders' bargaining power with management in respect of better disclosure, it did not lead to an increase in defensive management. No direct reporting requirements by auditors, weak public enforcement, and an insufficient independent director system complementarily prevent any increase in the bargaining power of monitors, and as a result, management does not need to be defensive.¹⁷¹

¹⁶⁸ Usually, the government exercises its influence over the incentive bargain among the four players through the corporate personality of the firm, through either taxation or industrial regulation. Sometimes, however, governmental regulations directly address a specific player. The latter mode of regulation strongly impacts the incentive bargain among the four players, although even the former mode of regulation cannot be said to be neutral to the incentive bargain.

¹⁶⁹ See Leonce L. Barger et al., *Sarbanes–Oxley and Corporate Risk-Taking*, 49 J. ACCT. & ECON. 34 (2010); Kate Litvak, *Defensive Management: Does the Sarbanes–Oxley Act Discourage Corporate Risk-Taking?* (Working Paper 2008); Qiang Kang et al., *The Sarbanes–Oxley Act and Corporate Investment: A Structural Assessment*, 96 J. FIN. ECON. 291 (2010); Shishido & Osaki, *supra* note 62.

¹⁷⁰ Overly aggressive disclosure regulations also may lead management to excessive risk-taking. See Hermalin, *supra* note 6.

¹⁷¹ See Shishido & Osaki, *supra* note 62. However, the fact that the documentation requirement of J-SOX decreases the autonomy of each sector's employees and discourages their creativity has been criticized.

I.6.4 Industry Regulations and Informality

Besides taxation and public enforcement of laws, the government also monitors corporations that belong to a certain industry via industry regulation. The government, as the delegate of consumers, monitors and negotiates with industry associations and their member corporations. The four players of each corporation in a certain industry are subject to such pressure from the government as a given infrastructural component of the incentive bargain.¹⁷²

The government negotiates with an industry not always based on specific laws but often in informal ways. Such negotiations seldom take a coercive form, but are usually a request for voluntary cooperation in pursuit of statutory or extra-statutory policy goals. Administrative informality does not only exist in Japan. Negotiation efforts during US administrative processes are substantially similar to Japanese administrative guidance in pursuit of statutory policy goals.¹⁷³

I.7 CONCLUSIONS

In conclusion, the previous discussions are summarized from the perspective of the incentive bargain of the firm as a repeated game; a legislative policy is then proposed for enhancing the efficiency of the incentive bargain of the firm, which this chapter refers to as legislating through backward induction.

I.7.1 Repeated Game

The incentive bargain of the firm is a repeated game (see Table I.1). In stage 0, the four players design contracts establishing incentive patterns. They also agree on methods for sharing control and sharing value added. In stage 1, each player provides their own capital and management executes the business plan. In stage 2, the players monitor each other and share the realized value added. Management also proposes financing and

¹⁷² Although politically there is room for negotiation, this chapter does not take it into consideration.

¹⁷³ See Takehisa Nakagawa, *Administrative Informality in Japan: Governmental Activities Outside Statutory Authorization*, 52 ADMIN. L. REV. 175 (2000). This observation related to administrative informality may lead one to see government as a fifth player in the bargain, a topic which I intended to address in the future.

Table I.1 Stages of the game

-
- Stage 0
 - Design contracts establishing incentive patterns
 - Agreements for sharing control and sharing value added
 - Stage 1
 - Each player provides capital
 - Execution and monitoring
 - Stage 2
 - Players share value added
 - Management proposes plan for next stage
 - Stage 3
 - Usually, start again from stage 1
 - Possibly, return to stage 0 (end-game)
-

business plans for the next stage. And in stage 3, the players usually start again from stage 1, but in end-game scenarios they return to stage 0.

Stage 0 is the bargaining stage before contracts are entered into. As with the choice of incentive patterns,¹⁷⁴ the importance of firm-specific investments in the industry,¹⁷⁵ the liquidity of the external labor markets,¹⁷⁶ social norms,¹⁷⁷ and laws and practices which encourage or discourage coalitions among the players¹⁷⁸ are particularly influential. Sharing control among the players in a way which reduces the risk to each player is particularly influenced by corporate law,¹⁷⁹ bankruptcy law,¹⁸⁰ and labor law.¹⁸¹ Sharing value added in a way which creates positive incentives between each of the players is influenced by each player's market power and characteristics prior to contract formation.

Stage 1 is the execution stage. Each player provides capital to the firm based on the agreements made in stage 0. The potential for renegotiation in the future will, however, distort the incentive of the players, particularly employees, when they provide their capital.¹⁸² Management then executes the business plan.

¹⁷⁴ See *supra* notes 7–24 and their accompanying text.

¹⁷⁵ See *supra* notes 19, 24 and their accompanying text.

¹⁷⁶ See *supra* notes 18, 22, 36–39 and their accompanying text.

¹⁷⁷ See *supra* notes 15, 22, 37–39 and their accompanying text.

¹⁷⁸ See *supra* notes 16–17, 23, 28–39, 47–48 and their accompanying text.

¹⁷⁹ See *supra* notes 84–117 and their accompanying text.

¹⁸⁰ See *supra* notes 57, 72 and their accompanying text.

¹⁸¹ See *supra* notes 42–45, 49–52 and their accompanying text.

¹⁸² See *supra* note 46 and its accompanying text.

Stage 2 is the after-contract stage of bargaining, including both monitoring and renegotiation. The provision of human capital needs to be monitored; employees are monitored by management, and management is monitored by shareholders and creditors. Overly aggressive monitoring, however, discourages human capital providers from making firm-specific investments. Furthermore, balancing autonomy and monitoring is important,¹⁸³ and renegotiations are frequently necessary. Changing employment contracts is a typical form of renegotiation.¹⁸⁴ Financing decisions also involve an aspect of renegotiation, including the choice between debt finance or equity finance and the choice between distributing dividends or retaining earnings.¹⁸⁵

Stage 3 is possibly the end-game stage between human capital providers and monetary capital providers. Legal regulation is indispensable here because serious conflicting interests will occur at this stage. Legislation needs to maintain a good balance between buyers and sellers in take-over regulations,¹⁸⁶ and between the *ex ante* and *ex post* incentives of the players in bankruptcy regulations.¹⁸⁷

I.7.2 Legislating through Backward Induction

New legislation in the field of enterprise law not only directly affects the actual practice of the firm, but also indirectly affects the incentive bargain between the four players.¹⁸⁸ Therefore, if the legislature alters enterprise law in an attempt to change the practice of the firm, the new law may cause unpredictable effects to the current practice as legal reforms can change the premises of the incentive bargain.¹⁸⁹

When drafting new legislation, there are two complementarities that need to be taken into account. First are the complementarities between relevant laws; particularly, substantive rules and enforcement systems

¹⁸³ See *supra* notes 5–6, 83–84, 125, 134–136 and their accompanying text.

¹⁸⁴ See *supra* notes 46–55 and their accompanying text.

¹⁸⁵ See *supra* notes 81, 119–120 and their accompanying text.

¹⁸⁶ See *supra* notes 122–125 and their accompanying text.

¹⁸⁷ See *supra* notes 69–79 and their accompanying text.

¹⁸⁸ If enterprise law is too restrictive for the players to make an efficient incentive bargain, affected players will push the legislature to change the law towards deregulation. This type of reformation of law is termed “demand pull legislation”. See Shishido, *supra* note 5, at 656.

¹⁸⁹ Unintended consequences often arise, particularly due to crisis-driven financial legislation. Inclusion of a sunset provision is useful in mitigating such legislative failures. See Roberta Romano, Chapter 21 in this volume.

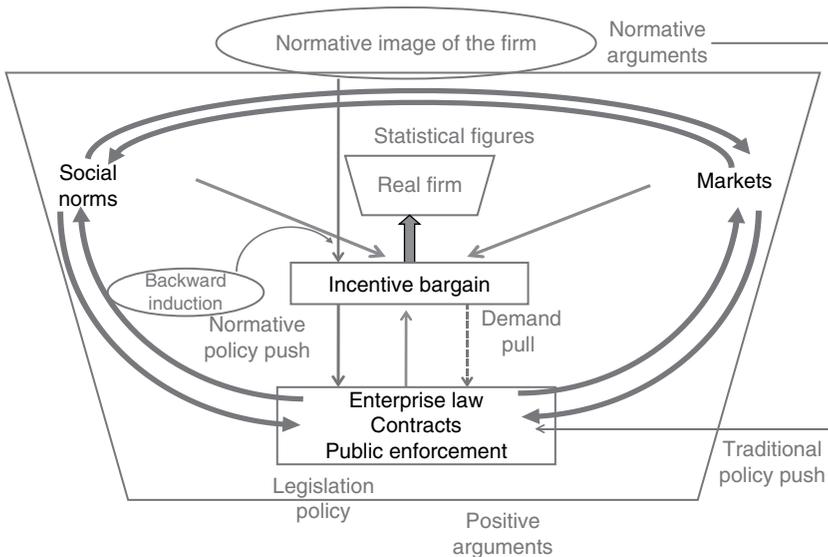


Figure I.6 Legislating through backward induction

complementarily affect reality.¹⁹⁰ Second are the complementarities between different infrastructures; it is important to note that enterprise law is only one of the infrastructures related to the incentive bargain and that it affects the incentive bargain complementarily with other infrastructures, such as markets and social norms.

Legislatures need to engage in backward induction simulations when trying to create law that aims to change the practice of the firm from the actual practice to a desired practice. This can be called “policy push legislation.”¹⁹¹ A traditional argument for policy push legislation is that enterprise law should be adapted to influence the firm to conform to what is considered desirable practice. Enterprise law itself, however, does not have the ability to recreate the firm into an entity that matches the desired normative image. If one has a normative image of the desired practice of the firm, one must also consider the incentive bargain between the four players, as the only way to alter the actual practice of the firm is by changing the bargains made between the players. Following this, one must consider what legal infrastructure is necessary to make such an incentive bargain possible (see Figure I.6).

¹⁹⁰ See Hoshi, *supra* note 104.

¹⁹¹ See Shishido, *supra* note 5, at 656.

I.7.3 Incentive, Complementarities, and Optimal Balance

In response to the question of how to create a legal system which stimulates an efficient incentive bargain at the firm level and enhances the efficiency of the whole economy, the general answer is simple, although detailed answers on specific points become complicated. First, focus on the incentives of the indispensable capital providers of the firm and the incentive bargain between such providers. Second, take into consideration complementarities between markets, social norms, and laws that affect the incentive bargain of the firm. And third, try to maintain an optimal balance between competing interests, particularly between the autonomy of management and monitoring by shareholders.

