

Japan Is Changing: Freedom of Change and the Complementarity between Inter- and Intra- Corporate Systems

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Abstract

In the Japanese corporate system from the 1960s to the 1980s, three factors—strong internal governance (i.e., company community), weak external governance (i.e., mochiai-main bank governance), and relationship-based B2B transactions (i.e., keiretsu)—were considered to be complementary of each other.

Today, Japan is changing. Amidst this process of change, we observe the following two phenomena. First, within a single country, there are various speeds and directions of change, depending on the industry and the company. Second, while B2B transactions and external governance have changed in many respects, it seems as though internal governance has not changed as much.

These two phenomena can be explained by the following hypothesis. First, B2B transactions and corporate governance are complementary, and can be characterized by a balance between exit-oriented factors and trust-oriented factors. Second, internal governance and external governance are substitutive. The corporate governance of each company will strike a balance between the two. And third, the speed of change is different between B2B transactions and corporate governance because internal governance is not easy to change without strong initiative by the controlling shareholder.

I. Introduction

In the Japanese corporate system from the 1960s to the 1980s (the classic J-form), three factors—strong internal governance, weak external governance,¹

¹ Corporate governance as a whole consists of internal governance and external governance. See Viral V. Acharya, Stewart C. Myers, & Raghuram G. Rajan, *The Internal Governance of Firms*, 116 *J. F.* 689 (2011). Regarding Japanese internal and external governance, see Takaaki Eguchi & Zenichi Shishido, *The Future of Japanese Corporate Governance: Japan's Internal Governance and Development of Japanese-style External Governance through Engagement*, in *Research Handbook on Shareholder Power* 552 (Randall Thomas & Jennifer Hill eds, 2015); Hokuto Dazai, Takuji Saito, Zenichi Shishido, & Noriyuki Yanagawa, *Japanese Corporate Governance from the Perspective of Family Firms* (SSRN 2016).

and relational B2B transactions²—were complementary (the three-factor simultaneity model). In other words, the three components of the classic J-form— company community,³ mochiai (cross-shareholding)-main bank governance, and the keiretsu transaction⁴—were strongly correlated and influenced each other.⁵

Today, Japan is changing. The classic J-form has changed since the 1985 Japanese economic bubble, particularly during the turnaround period following the 1997 Japanese financial crisis. Capital markets have dramatically changed: main banks have retreated and mochiai has dissolved, to be replaced by institutionalization and internationalization.⁶ Since the 1990s, technological innovation has changed how product markets operate. Particularly due to rapid modularization, relation-specific investments have become less important.⁷ The costs of keiretsu transactions have overwhelmed their benefits.

Amidst this process of change, we observe the following two phenomena.

First, the ongoing change is not aligned with the three-factor simultaneity model. Although B2B transactions and external governance have changed in many respects, internal governance has seemingly not changed as much (i.e., the company community remains robust).

Second, the change is varied. Within a single country, change has taken multiple speeds and directions, depending on the industry and the company. The change has led to multiple ways of making a product.

² B2B transaction here is the abbreviation of the relationship between OEMs and suppliers in manufacturing industries.

³ See Zenichi Shishido, Japanese Corporate Governance, The Hidden Problems of the Corporate Law and Governance, 25 Del. J. Corp. L. 189 (2000).

⁴ See Ronald Gilson & Mark J. Roe, Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization, 102 Yale L. J. 871 (1993).

⁵ See generally Masahiko Aoki, Toward an Economic Model of the Japanese Firm, 28 J. Econ. Lit. 1 (1990).

⁶ See Hideaki Miyajima & 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); Hideaki Miyajima & Ryo Ogawa, Convergence or Emerging Diversity?: Understanding the Impact of Foreign Investors on Corporate Governance in Japan (RIETI Discussion Paper 2016).

⁷ See Tomoatsu Shibata, Nihon Kigyo no Suriawase Noryoku---Moju-ruka wo Koete [Integration Ability of Japanese Companies---Beyond the Modularization] 49, 52 (2012).

These two phenomena can be explained by the following hypothesis.

First, both B2B transactions and corporate governance consisting of internal and external governance can be characterized by a balance of exit-oriented and trust-oriented factors. They are complementary in the sense that trust-oriented B2B transactions and trust-oriented corporate governance (the J-form) will create higher payoffs, while exit-oriented B2B transactions and exit-oriented corporate governance (the A-form⁸) will also create higher payoffs. There are numerous pairings of exit-oriented factors and trust-oriented factors that create the optimal balance. This creates freedom of choice.

Second, internal governance based on the trust-oriented relationship and external governance based on the exit-oriented relationship function as substitutes. With stronger external governance, internal governance becomes correspondingly weaker. The opposite is true. Accordingly, the corporate governance of each company will strike a balance between the two.

And third, the speed of change is different between B2B transactions and corporate governance. While B2B transactions are required to change quickly in response to changes in the product market, corporate governance tends to maintain the status quo because of numerous exogenous factors acting as a heavy anchor. Internal governance is, particularly, not easily changed without strong initiative by the controlling shareholder.

Chapter II describes the classic J-form and its three aspects: internal governance, external governance, and B2B transactions. Chapter III describes how the classic J-form has changed, and particularly, the non-simultaneous change of the three aspects and varied changes in different industries and different companies. Chapter IV proposes our hypothesis to explain the reasons behind these varied and non-simultaneously changes. Chapter V adapts our hypothesis to specific examples of changes. Chapter VI posits our conclusion.

II. Classic J-Form: The Three-Factor Simultaneity Model

Strong internal governance, weak external governance, and relational B2B transactions were a complementary set. The three components of the classic J-form— company community, mochiai-main bank governance, and a

⁸ A-form is the abbreviation of the typical American business system.

keiretsu transaction– were strongly correlated and influenced each other.⁹

A. J-Form’s Strong Capacity for Internal Governance

Acharia et al. analyze corporate governance as the set of internal governance and external governance. Internal governance is a form of incentive bargaining between the top manager and junior managers. The bottom-up pressure from junior managers incentivizes the top manager to become a value-builder for future generations.¹⁰ Internal governance is inherently biased towards growth because the top manager needs to keep persuading her subordinates that the future value of the firm will be greater than today’s.

The classic J-form had a strong capacity for internal governance in the following two ways.

First, J-form firms met three conditions for the effective operation of internal governance: the prospect of a long-term career within the organization;¹¹ the practice of internal promotions for the top manager;¹² and, the practice of long-term reward among its constituents.¹³

Second, J-form’s internal governance is not only between the top manager and junior managers, but also between the top manager and all core employees.¹⁴

⁹ See generally Aoki, *supra* note 4.

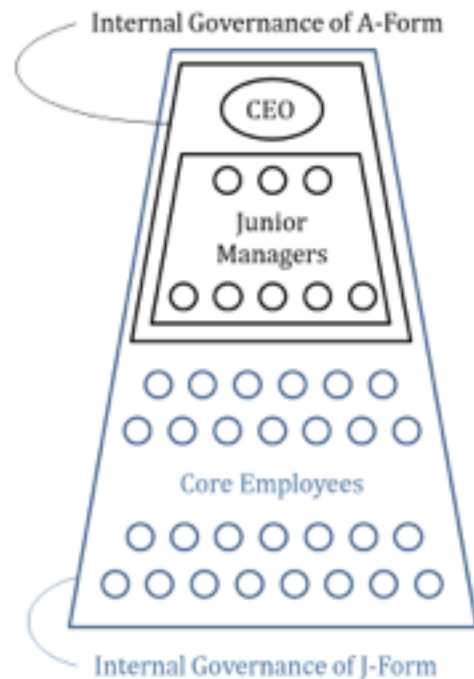
¹⁰ See Acharia et al., *supra* note 1.

¹¹ Ono 2010

¹² Mishina & Hino 2013

¹³ Moriguchi & Ono 2006

¹⁴ See Dazai, et al., *supra* note 1.



B. J-Form's Weak External Governance

In comparison to its strong internal governance, the classic J-form's external governance was weak.

The practice of cross-shareholding had been used to shield management from the influence of outside shareholders. In post-war Japan, shareholders were legally empowered and a dispersed ownership structure prevailed. Networks of cross shareholding were developed as measure against outside hostility. In practice, cross-shareholding prevented both exit and voice.¹⁵

Although the main bank served as the most important measure of external governance for Japanese companies, the relationship was not aimed at maximizing shareholder value. From the creditors' perspective, the measure functioned as a monitor. Furthermore, the main bank's contingent governance meant that it will not intervene unless the company creates red ink.¹⁶

¹⁵ See Zenichi Shishido, Introduction: The Incentive Bargain of the Firm and Enterprise Law: A Nexus of Contracts, Markets, and Laws, in *Enterprise Law* 1, 35 (Zenichi Shishido ed., 2014).

¹⁶ See Yasuhiro Arikawa & Hideaki Miyajima, Relational Banking in Post-Bubble Japan: Co-Existence of Soft and Hard Budget Constraint, in *Corporate Governance in Japan: Institutional Change and Organizational Diversity* 51 (Masahiko Aoki, et al. eds, 2007).

The board of directors, which is the intersection between internal governance and external governance, was an exclusively insider board. The concept of a monitoring board where independent outside directors monitor management was not existent.

In a sense, the company's organizational capacity for internal governance is preserved by limiting excessive external governance through cross-shareholding, the main bank system, and the exclusively insider board.

After the Japanese economic bubble, the growth bias inherent in internal governance caused wasteful investments, while external governance was ineffective.¹⁷

C. J-Form's Relational B2B Transactions

The relationship between OEMs and suppliers (B2B transactions) in the classic J-form was based on the long-term relational contract. The "non-switching practice" during a continuing model encouraged suppliers to make relation-specific investments. The ranking system of suppliers was a mirror image of the rank hierarchy of intra-corporate system. It incentivized suppliers to compete with each other to develop more efficient production systems. Changes to OEMs governance system of suppliers depended on the developing stage of a supplier. Close cooperation was kept across firms based on the integral architecture of manufacturing.¹⁸

III. How the J-Form Has Changed

A. Japan Is Changing, Not Simultaneously but Variedly

The Japanese business system (J-form) has been changing during the last 30 years. However, the three complementary factors of the classic J-form: strong internal governance, weak external governance, and relational B2B transactions, did not change simultaneously. Although B2B transactions and external governance have changed in many respects, internal governance has not changed as much.

We can also observe variations of change. Even within a single country, change takes various speeds and directions, depending on the industry and the company. Typical variations are found between the automobile and

¹⁷ See Eguchi & Shishido, *supra* note 1.

¹⁸ See generally Banri Asanuma, *Manufacturer-Supplier Relationship in Japan and the Concept of Relation-Specific Skill*, 3 *J. Japanese Int'l Econ.* 1 (1989).

electronics industries, and between Toyota and Nissan.

B. Varied Changes in Different Industries

Let us now compare the changes in two typical Japanese manufacturing industries: the automobile and electronics industries.

1. Current B2B Transactions in the Electronics Industry

OEMs purchase fewer customized parts and more commodity parts due to rapid modularization and severe global competition. Commoditization made relation-specific investments less important, and most OEMs abolished their supplier associations.¹⁹ B2B transactions changed quite radically from long-term relational contracts to market-oriented contracts.²⁰

Japanese electronics used to have very competitive advantage in the global market, which was considered to be the result of keiretsu transactions. In these transactions, OEMs encouraged their parts suppliers to make relation-specific investments based on heavily trust-oriented B2B relationships.²¹

In electronics manufacturing, the commoditization of parts proceeded rapidly in the 1990s; at the same time, international price competition revealed itself to be quite harsh. Commoditization made relation-specific investments less important and price competition forced OEMs to cut procurement costs by leveraging market competition among parts suppliers worldwide.²²

2. Current Corporate Governance of Electronics Companies

External governance has strengthened through increases in foreign institutional investors' shareholdings and the use of independent directors, which follow the 2015 "corporate governance reform" trends.

¹⁹ See Makiko Shimizu, *Mojuru-ka to "Nihonteki Torihiki-kanko": Chosa no Kasetsu to Bunseki* [Product Architecture and Japanese Contracting Practices: Hypothesis and Analysis] 2142 *Shojihomu* 17, 23 (2017).

²⁰ See Motokazu Endo & Kazuaki Kinoshita, *Torihiki-jitsumu no Henyo to Torihiki Kihonkeiyaku* [Changes of Manufacturer-Supplier Relationships and Boilerplate Contracts] 2142 *Shojihomu* 40, 43.

²¹ See Endo & Kinoshita, *supra* note 20, at 42-43.

²² See Shimizu, *supra* note 19, at 23-24; Endo & Kinoshita, *supra* note 20, at 43.

Strong internal governance based on long-term employment relationships looks, however, has not changed so much.

3. Current B2B Transactions in the Automobile Industry

In the automobile industry, too, OEMs have moved towards modularization and purchase more commodity parts, but to a lesser degree than in the electronics industry.²³ The importance of relation specific investments has not decreased as much, and close cooperation across firms has persisted.²⁴ In addition, most makers keep their supplier associations.²⁵ Therefore, the B2B relationships in the automobile industry has not yet dramatically changed course towards one that is more exit-oriented, and instead continues to maintain substantial trust-oriented factors.

C. Varied Changes in Different Firms

Within the Japanese automobile industry, Toyota and Nissan, the No.1 and No.2 automobile makers, provide an interesting comparison. Although both makers are from the same country and operate successfully within the same industry, they take very different approaches to both their B2B relationships and their corporate governance.

1. The Case of Nissan

After a decade of poor performance during the 1990s, Nissan almost went bankrupt. Instead, in 1999, the company accepted a 44 percent equity investment and a new CEO from Renault France.²⁶

In its B2B transactions, Nissan abandoned its traditional keiretsu transaction. It eliminated its equity relationships with parts suppliers,²⁷ decreased the number of exchanging personnel,²⁸ and increased its price

²³ See Endo & Kinoshita, *supra* note 20 at 42.

²⁴ See Endo & Kinoshita, *supra* note 20 at 42.

²⁵ Shimizu, *supra* note 19, at 23.

²⁶ See Koichi Shimokawa, et al., Nissan Jidosha Ribaibaru Puran to Nissan Jidosha Hanawa Kaicho • Gohn Shacho Intabyu Kiroku [Nissan Automobile Co.'s Revival Plan and Interview Record of Chairman Hanawa and President Ghosn of Nissan Automobile Co.] 40-3 Keiei Shirin 45 (2003); Jiro Uesugi, Nissan Jidosha no Shippai to Saisei [Failure and Turnaround of Nissan Automobile Co.] (2001).

²⁷ See Uesugi, *supra* note 26, at 113-115.

²⁸ See Uesugi, *supra* note 26, at 106.

bargaining power by decreasing the number of suppliers and implementing open bids.²⁹

Since the “Ghosn Reform” of 1999, Nissan’s B2B relationships and corporate governance have changed in complement from more trust-oriented factors towards implementing substantial exit-oriented factors.

2. The Case of Toyota

Toyota, in contrast, has taken a different approach than Nissan.

In its B2B transactions, Toyota mostly maintains the traditional keiretsu transaction with its parts suppliers. The transacting parties pledge their commitment based on long-term relational contracts between mostly fixed parties. The “three elements” of the keiretsu transaction have remain unchanged: equity relationship, personnel exchange,³⁰ and supplier association.

As for corporate governance, Toyota maintains strong internal governance based on the company community norm.

IV. Reasons for Varied and Non-Simultaneous Changes

We would like to propose three hypotheses to explain why the J-form has undergone varied and non-simultaneous change. First, both B2B transactions and corporate governance can be characterized by a balance of complementary exit-oriented factors and trust-oriented factors. There are numerous pairs which can achieve this complementary balance. Second, internal governance and external governance function as substitutes. The corporate governance of each company will strike a balance between the two. And third, the speed of change differs between B2B transactions and corporate governance.

A. The Trust-Oriented Factors and the Exit Oriented Factors in Both B2B Transactions and Corporate Governance

The trust-oriented relationship is one wherein the players respect each other’s interests much like a mutual fiduciary relationship. It encourages players to make relation-specific investments, but it is accompanied by opportunity costs.

²⁹ See Shimokawa, et al., *supra* note 26, at 52-53, 59-60; Uesugi, *supra* note 26, at 101-103.

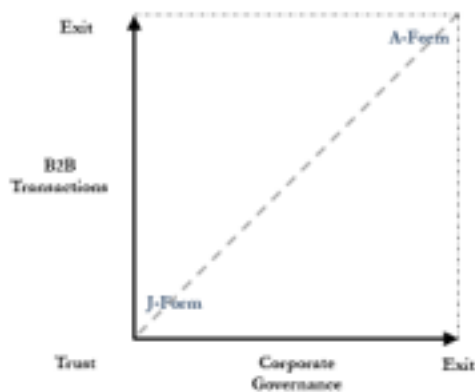
³⁰ See Uesugi, *supra* note 26, at 110-111.

The exit-oriented relationship is one wherein the players monitor each other through the threat of exit. It benefits from market competition, but it is hard to persuade players to make relation-specific investments.

Players can choose an optimal balance between the two extremes.

If the product market requires relation-specific investments, B2B transactions will need to strike a balance that is more trust-oriented. Corporate governance with strong internal governance can complement a commitment to not change business policies.³¹

If the product market requires less relation-specific investments, the opportunity cost of a more trust-oriented balance in the B2B transactions may overwhelm the benefit of relation-specific investments. The B2B transactions will be forced to shift towards a more exit-oriented balance. The role of commitment schemes will diminish and companies will be pressured to shift to a more exit-oriented balance in order to take advantage of market competition in both labor and control markets.



³¹ Regarding the importance of commitment not to change the firm's operating strategy to its business partners, see Ronald J. Gilson & Alan Schwartz, *Corporate Control and Credible Commitment*, 43 *Int'l Rev. L. & Econ.* 119 (2015); William C. Johnson, Jonathan M. Karpoff, & Sangho Yi, *The bonding Hypothesis of Takeover Defenses: Evidence from IPO Firms*, 117 *J. Fin. Econ.* 307 (2015).

B. Internal Governance and External Governance Are Substitutive

Internal governance is based on the trust-oriented relationship. External governance is based on the exit-oriented relationship. With stronger external governance, internal governance becomes correspondingly weaker. The opposite is true. The corporate governance of each company will strike a balance between the two.



C. The Speed of Change Differs between B2B Transactions and Corporate Governance

Corporate governance generally does not need to change as quickly as B2B transactions do in response to changes in the product market.

Corporate governance tends to maintain the status quo. Exogenous factors such as employment protection laws, external labor markets, labor unions, and social norms, function as a heavy anchor against changes. Internal governance is not easily changed without strong initiative by the controlling shareholder.

V. Adaptation of the Hypothesis

A. Toyota and Nissan

Relation-specific investments are still required in the automobile industry,³² so there is some room for choice in B2B transactions, as to how much each company introduces exit-oriented factors and keeps trust-oriented factors.

Each company chooses its idiosyncratic pairing based on the characteristics and the capacity of the company. Since the “Ghosn Reform” of 1999, Nissan’s B2B relationships and corporate governance have changed in complement from more trust-oriented towards implementing substantial exit-oriented factors. Relative to Nissan, Toyota retains the capacity to effectively maintain a more trust-oriented pairing of B2B transactions and corporate governance.³³

During the 1990s, Nissan’s corporate governance and B2B relationships were too trust-oriented with few exit-oriented factors. They were unable to prevent the company community³⁴ and the keiretsu suppliers³⁵ from pursuing private benefits, which led to malfunction. Nissan changed after its acquisition by a foreign shareholder (Renault) and through the initiative of its new foreign CEO (Carlos Ghosn). Mr. Ghosn implemented exit-oriented factors in both corporate governance³⁶ and B2B relationships,³⁷ thereby improving them.³⁸

Toyota is a family firm. Japanese family firms’ CEOs who are descendants of the founding family, in general, have equity incentive to prevent the company community from pursuing its private benefit.³⁹ Toyota’s corporate governance reflects strong internal governance, in which core employees

³² See Shimizu, *supra* note 19, at 22.

³³ See Uesugi, *supra* note 26, at 103.

³⁴ Particularly, its company labor union had too much voice. See Shimokawa, et al., *supra* note 26, at 46, 48. “Sectionalism” is also pointed out as a big problem of Nissan’s intra-corporate system before Ghosn. See Shimokawa, et al., *supra* note 26, at 52; Uesugi, *supra* note 26, at 67.

³⁵ See Shimokawa, et al., *supra* note 26, at 52; Uesugi, *supra* note 26, at 94, 103.

³⁶ See Uesugi, *supra* note 26, at 171.

³⁷ See Shimokawa, et al., *supra* note 26, at 52; Uesugi, *supra* note 26, at 113.

³⁸ 68 billion yen red ink in 1999 was improved to 33 billion yen black ink in 2000. See Uesugi, *supra* note 26, at 4.

³⁹ See Dazai, et al., *supra* note 1.

care for the firm's long-term value,⁴⁰ and can prevent the keiretsu from turning to collusive methods. In other words, Toyota retains the capacity to effectively maintain a more trust-oriented pairing of B2B relationships and corporate governance.

B. Electronics Companies

In comparison with Japanese automobile companies, why do Japanese electronics companies not aim to establish complementary pairings of B2B relationships and corporate governance?

Unlike in the automobile industry, modularization in the electronics industry was more rapid and radical. As relation-specific investments become obsolete, freedom to change is eliminated in B2B transactions. All companies were forced to shift from the trust-oriented B2B relationship to the exit-oriented B2B relationship, which reduced procurement costs by implementing market competition.

The electronics industry's corporate governance is, however, still more heavily oriented towards trust. Although companies' external governance has strengthened in terms of increases in foreign institutional investors' shareholdings and the use of independent directors, their internal governance remains strong and has not significantly changed. In particular, strong employment protection laws, illiquid external labor markets, company unions, and company community social norms function as an anchor against change.

If external governance is strengthened by an increase in outsider shareholders, such as foreign institutional investors, the internal governance will weaken correspondingly because strengthened shareholder monitoring will restrict the autonomy of internal governance. However, the substance of internal governance, such as the company community, will not change until the company is acquired by foreign capital. Foreign institutional investors typically own less than five percent each and will not intervene in the human relationships. Rather, they can use their voice to change the structure of the board and the business model.

C. US Big Three

Another non-complimentary pairing can be observed in the US automobile industry.

⁴⁰ Substantial numbers of Toyota's employees are second- or third-generation life-time employees.

Since the late 1980s, companies operating in the US automobile industry have changed their B2B transactions from more exit-oriented to more trust-oriented due to strong competitive pressure from Japanese automobile companies.⁴¹

Their corporate governance is, however, still heavily leans towards exit, with strong external governance and weak internal governance. Complementary changes have not been observed. This is likely due to the fact that weak employment protection laws, liquid external labor markets, industry unions, and shareholder-oriented social norms function as an anchor against change in the exact opposite way as they do in Japan.

D. NUMMI

An optimal complementary pairing has been created within the US automobile industry. NUMMI, a joint venture between Toyota and GM, is this outlier case. NUMMI was created in 1984 in Fremont, California, using a GM assembly plant that had been closed for many years.⁴²

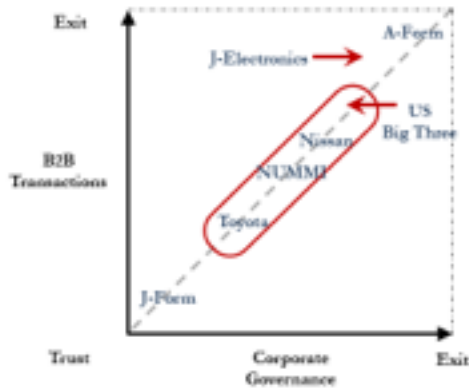
As the managing partner, Toyota tried to implement its production system in the joint venture with GM, both in the venture's B2B transactions⁴³ and corporate governance.⁴⁴ As a result, an optimal complementary pair was realized.

⁴¹ See Ronald J. Gilson, Charles F. Sabel, & Robert E. Scott, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, 109 Colum. L. Rev. 431, 435 (2009).

⁴² The Joint venture was dissolved in 2010. GM pulled out of the venture in June 2009 due to its bankruptcy, and several months later Toyota decided to pull out.

⁴³ See "Jonson Controls, Inc-Automotive System Group: The Georgetown, Kentucky Plants," Stanford University Case BE-9 (1997).

⁴⁴ See Zenichi Shishido & Atsushi Kusano, Kokusai Goban: Toyota=GM Jointobencha no Kiseki [International Joint Ventures: A Case Study of Toyota-GM Joint Venture] (1988).



VI. Conclusion

Any successful business system needs to adapt to the changing markets: product, capital, and labor markets. Recent technological innovation, in particular, modularization, changed the product market and forced changes in Japanese B2B transactions. Modularization decreased the significance of relation-specific investments. When relation-specific investments are important, OEMs are incentivized to create more trust-oriented B2B relationships to encourage suppliers to make the needed relation-specific investments. Once relation-specific investments become less important, OEMs must shift to more exit-oriented B2B relationships to take advantage of cost reductions through open bids.

Corporate governance that is more trust-oriented, which guarantees a commitment to not change business policies, should be complementary with more trust oriented B2B transactions. Likewise, corporate governance that is more exit-oriented can take advantage of market competition in both labor and capital markets and should be complementary with more exit-oriented B2B transactions.

Actual changes in the Japanese business system are not necessarily complementary, but vary depending on the industry and individual company. Companies in industries with slower technological change can enjoy more freedom to change given the availability of numerous complementary pairings of inter- and intra-corporate systems. Deviation from

complementary pairings may occur because the speed of change is different between B2B transactions and corporate governance. Particularly, internal governance is not easily changed without strong initiative by the controlling shareholder.