CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

1 *Introduction: hedge fund activism, Japanese corporate governance, and the nature of the company*

This book is about corporate governance in Japan, as it was revealed through a particular series of interactions between activist hedge funds, target boards, and other interested parties between roughly 2000 and the full onset of the global financial crisis in 2008. At the same time it is an account of a clash between two different conceptions of the company: the view promoted by activist hedge funds of the company as the shareholders' property, which we call 'shareholder primacy', and the view predominant in Japan of the company as an enduring organisation or a 'community'. This was an unusual instance of two distinct conceptions of corporate governance encountering one another within a single national market. Where the disagreements became public, they brought fundamental and often hitherto tacit assumptions about the purpose of the company into the open. The result was in many ways a demonstration of the strengths and weaknesses of both approaches, making it also a story with a wider significance, with implications for regulatory policy and corporate practice beyond Japan.

The tension between the idea of the company as property and the idea of it as community originates in the nature of the institutional form which describes the business enterprise in modern market economies: the joint stock company.[1] This is a legal form which has evolved over time and in a number of different national and commercial contexts to meet business needs. Its nature cannot be understood without taking into account certain of its features, which include separate personality and limited liability, which would not exist without a legal underpinning

[1] In this book we use the expression 'joint stock company' as a generic term to refer to companies which are limited by share capital and either have, or legally could have, at least some shareholders who are not directly engaged in the management of the business. Different legal systems use various terms to describe this widely observed business form. The Japanese expression '*kabushiki kaisha*' approximately translates as 'joint stock company'.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

of some kind. The joint stock company is, however, more than just the legal model of the firm. That legal model is a response to and reflection of organisational practices, market pressures, and political forces which have shaped the law. How companies are governed is the result not just of a certain legal framework, but depends additionally on institutional norms and practices of differing degrees of formality, which vary from country to country and from one market context to another. These practices may complement the formal rules of company law, but they may also contradict them, or render them irrelevant. Outward resemblances among formal laws and regulations may be misleading as a guide to corporate governance on the ground. In this book, while we take account of the law in shaping corporate experience, our main focus will be on practice as revealed by empirical investigation.

Against the background of a corporate governance system incompletely defined by law and necessarily supplemented and amended by institutional practice, solutions to the long-standing problem of the 'separation of ownership and control' in the structure of the joint stock company were pioneered in the USA and UK. The rise of shareholder primacy in those markets can be traced to intellectual currents in financial economics and the theory of the firm in the 1970s, which found a practical manifestation in the hostile takeover movement and growing role of independent boards in the following decades. Underpinning these solutions was the view that shareholders were the ultimate or 'residual' owners of the company and that the directors and managers were their agents, whose duty was to generate 'shareholder value' before all other considerations. Other so-called 'stakeholders', such as employees and customers, were acknowledged to be of importance to the success of the company as a business, but they had no direct role in its governance. The emergence of these ideas and practices was triggered by corporate scandals in America and Britain, and assisted by the lobbying of influential groups, including institutional shareholders such as pension funds, insurance companies, and other collective investment vehicles which were coming to prominence as owners of corporate stock at this time. Because of their similarities, the US and UK approaches to corporate governance are often discussed in tandem as 'Anglo-American' but they are not identical. We look at the UK market's response to hedge fund activism in Chapter 5 but generally focus on American patterns of corporate governance because these have had a greater international impact. It was specifically the success of the US economy in the 1990s that helped to spread these ideas worldwide,

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

often to the point of eclipsing prior traditions of the company as a socially embedded entity which produced value for a range of different stakeholders including the shareholders, sustained over time by a management devoted to preserving the organisational identity of the firm.

In Japan, the search for mechanisms to deliver effective corporate performance had taken a different path since the late 1940s. Then, the priority had been national economic recovery, and the company was seen as a vehicle for achieving sustained growth of the kind needed to bring this about. A government bureaucracy accustomed to intervening in the economy encouraged a revival of industry with firms under the control of largely autonomous management, funded by bank finance rather than by equity capital. Shareholders, or at least pure portfolio shareholders investing for returns, played little part in this process. Their legal position as owners of shares, with the right to appoint and remove directors and thereby to hold management to account, was little different from that which prevailed in the USA and UK at this time. In some respects, the formal rights of Japanese shareholders were stronger and clearer than, for example, those of their American counterparts. Yet there developed in Japan a model of the 'community firm' which led to the almost complete marginalisation of shareholder voice. Initially motivated by the need to control labour unrest and later by the economic advantages, in terms of enhanced productivity, which were seen to flow from workforce involvement in the organisation of the firm, Japanese managers set out to cultivate a communitarian ethos, encouraging employees, up to and including the mostly executive boards, to identify with the company and to internalise its values. By the 1980s, bureaucratic intervention had receded and bank-led finance was less important for the larger and richer firms, leaving management effectively unsupervised, except by reference to the internal corporate ethic of the community firm. Directors and other senior managers tended to see themselves as representatives of the extended corporate community, which included past and present employees and long-term suppliers and customers. Retaining employee trust and loyalty on the one hand, and producing value for the firm's customers and for the firm itself on the other, were the twin objectives which, if met, would ensure the sustainability of the company over time.

The American and Japanese models were both, in their ways, responses to crisis, although crises of very different kinds and of different eras. US corporate governance took a pro-shareholder turn in response to scandals related to management behaviour, economic

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

recession, and concerns over a loss of international competitiveness in the 1970s. Japan's system, which originated in the period of post-war reconstruction in the 1940s, proved remarkably robust even in the changed circumstances of the later decades of the last century, including the period of economic stagnation which began with the bursting of the real estate and stock market bubble at the beginning of the 1990s. The Japanese system drew a veil over shareholders' property rights and was mostly conducted as if their legal status within the company simply did not matter. It provided few mechanisms to hold management to account should it abuse its position of trust. The growing contrast between the US emphasis on shareholder value and the Japanese indifference to shareholder rights was widely remarked on, but had few practical effects because the two systems had few opportunities to impact on one another. Beginning in the 1980s, the Structural Impediment Initiative talks between the US and Japanese governments created a degree of friction, as the US side called for changes in Japanese retailing practices, land use, and investment in public works, some of which touched on corporate governance issues. But the talks had few direct implications for the way companies in Japan were run. The growing international reach of institutional investors also had limited impact at this time, as senior Japanese managers reiterated the virtues of their model in the face of calls for heightened sensitivity to shareholder concerns.

All of this changed with the emergence of hedge fund activism in Japan. Activist hedge funds had appeared in the USA in the aftermath of the 'deal decade' of the 1980s. As the hostile takeovers of that period receded, new types of shareholder activism came to the fore. American activist hedge funds were often confrontational investors who targeted companies which they believed were squandering shareholder value. Through public engagement with the boards of companies in which they took important but not normally controlling stakes, the funds frequently succeeded in facilitating the release of free cash flow to shareholders in the form of increased dividends and share buy-backs. This often necessitated asset sales and restructurings, which, notwithstanding their negative implications for employees and other stakeholders, were justified by the activists as enhancing capital efficiency. As this strategy was successful in generating above-market rates of return for the funds and their own investors, they turned to other markets, in Europe and in Japan. In Japan, the approach of the

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

funds came into immediate conflict with the idea and practice of the community firm which still retained widespread support among managers, bureaucrats, and politicians in the early 2000s, despite the economic vicissitudes of the post-bubble period.

What followed was a tournament of corporate governance beliefs. Activist hedge funds, often of foreign origin, but sometimes Japanese, used the formal legal rights conferred on shareholders by Japanese company law and by companies' own articles of association to mount a fundamental challenge to the core of management practice in the community firm. In doing so, they drew out into the open a range of issues that had previously been uncontroversial concerning managerial autonomy and accountability, the balance in dividend policy between the distribution of income and the accumulation of reserves, and the optimal level of financial gearing for companies. Above all, hedge fund activism crystallised the debate over competing conceptions of the company as shareholders' property on the one hand and as the community firm on the other. With money and power at stake in these contests, and against a backdrop of sustained media and public interest, the debate was carried out at an unusually heightened level of engagement.

In this book we chart the progress of this debate, as it was conducted over several years through public dialogue between funds and boards, tender offers, litigation, and regulatory and bureaucratic responses. In particular, we examine why not just corporate managers but also many institutional investors in Japan resisted the activist hedge funds, and how they went about constructing their defence. We also make an assessment of why that defence, which was initially uncertain, was, in the end, largely successful. Because two diametrically opposed approaches to corporate governance were set against each other in an unusually clear way, the Japanese experience of hedge fund activism provides a rare opportunity to study, in a concrete setting, a clash of ideas which is otherwise only indirectly observable, or must be considered at a theoretical level, several removes from practice.

Our account of hedge fund activism in Japan is thus located in the context of the global development of the joint stock company as the principal legal form of business enterprise in market economies. We note its dynamic strengths as well as its inbuilt anomalies and weaknesses, and its need for complementary mechanisms of corporate governance, expressed through formal and informal norms and practices

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

beyond the law. We focus on the tension between the two divergent threads of corporate governance that we have referred to above, namely the property-rights, shareholder-orientated model of the company that has emerged from the historical experience of a number of countries but in particular the USA and UK, and the firm-centric, communitarian strand that emerged from Japan's period of post-war reconstruction. We see this tension as not just a consequence of the divergent experience of different national systems, but as inherent in the original form of the joint stock company itself. The rise of the activist hedge fund phenomenon, as it began in the USA and spread from there, can be seen as the drawing out, under contemporary conditions, of this inherent conflict of models. Hedge funds, despite their recent rise to prominence and the widespread attention given to them, represent only a small part of the total funds under professional management, even in the USA, and activist funds are a fraction, in turn, of the wider hedge fund category. Their importance lies not in the scale of their holdings, but in their conscious adoption of the language and strategy of shareholder primacy as the foundation of their investment approach. They were seen, and saw themselves, as the shock troops of shareholder primacy. That is why we are studying them.

Hedge fund activism in Japan during the period of our study was a calculated venture by professional fund managers; it is important to bear in mind that the funds did not set out primarily to reform Japanese management but to make a profit from their investments. Demanding reform was nevertheless a means to this end and the reactions that it provoked were often instructive. Thus, for our purposes, what matters is not whether particular funds were successful or made money for their investors, but what they revealed about corporate governance ideas in Japan and how far they brought about wider change in the Japanese corporate governance system. In addition to charting broad trends in hedge fund interventions across the period we are studying, we therefore look in detail at a small number of more confrontational funds which attracted the most interest in the Japanese press and whose activities had a marked impact on corporate practice and on the responses to activism of the courts and bureaucracy.

Chapter 2 continues our introduction by explaining the methodology we adopted for this study.

Chapters 3–7 establish the framework of our discussion, taking us through the development of the company to the split between property

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

rights and communitarianism, as it was played out in different markets, to the emergence of activist hedge funds. In Chapter 3 we look at the legal form of the joint stock company, the concept of corporate governance, and the way in which informal practices permeate and influence the ways that corporate governance is conducted. In Chapter 4 we look at the American and British experience of the rise of shareholder primacy from the 1970s onwards, and consider its significance for corporate governance at a global level. In Chapter 5 we look at the development of the hedge fund sector and its activist subsector in the USA, in the UK, and in Continental Europe. In Chapter 6 we look at the contrasting experience of Japan and the style of communitarian corporate governance that emerged there after the Second World War. In Chapter 7 we consider what attracted activist hedge funds to Japan, despite the existence of so many outwardly hostile factors.

Chapters 8–12 contain the core of our empirical analysis. Here we use a narrative approach to give a sense of the chronological unfolding of events. Chapter 8 looks at the emergence of hedge fund activism in Japan, beginning with the most prominent of the early Japanese funds, the so-called 'Murakami Fund', and describes the arrival of foreign funds in the early 2000s. We then provide an overview of the state of hedge fund activism in Japan at its height in late 2007, and look at the styles of activism pioneered by the five most high-profile funds during 2001–8. In Chapter 9 we provide more detailed accounts of two interventions which we consider confrontational and which proved to be turning points: Steel Partners' intervention in Bull-Dog Sauce and TCI's intervention in J-Power. Chapter 10 reports on the reactions to activism of managers, shareholders, the courts, the bureaucracy, the public, and the media, particularly the financial press in Japan and overseas. In Chapter 11 we look at the record and prospects of other activist hedge funds in Japan, which did not attract the same publicity as the more confrontational ones, but whose strategies may prove to be more enduring in a Japanese setting. In Chapter 12 we offer our conclusions. We consider what confrontational hedge fund activism revealed about Japanese corporate governance, review its significance for Japanese corporate and managerial practice, and discuss its wider implications for the nature of the company and the dynamics of global corporate governance.

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

2 *Perspectives, methods, and data*

2.1 Studying hedge fund activism in context

The basis of our study is an empirical inquiry into the dynamics of Japanese corporate governance during the 2000s. Our empirical research was conducted from an *institutionalist* theoretical perspective, and employed a *multiple methods approach* combining qualitative, quantitative, and narrative elements.

By an 'institutionalist' perspective we mean one which sees individual behaviour as both shaping and being shaped by enduring institutional features of a given societal context or environment. At their simplest, institutions consist of behavioural regularities or practices which, through repetition and routinisation, achieve a certain level of stability. The organisational practices of a business enterprise – the routines associated with the allocation of tasks between individual employees, team working, the exercise of supervisory authority, and so on – can possess this institutional quality on the basis of repeated behaviour. At a further level, when routines which are still largely tacit and informal acquire a certain degree of legitimacy in the eyes of those who observe them, they become norms which provide a benchmark for behaviour. Many of the practices of the large Japanese enterprise or community firm that we will be studying in this book, ranging from so-called 'lifetime' or stable employment for core employees to the marginalisation of external shareholders in corporate decision-making, make claims on the behaviour of corporate actors which are normative in this sense: claims which were contested by activist hedge fund managers who had a quite separate set of normative reference points. Norms, in their turn, can be formalised as written rules contained in texts which claim to offer authoritative guidance for behaviour and which, if they are embodied in a legal form, can be backed up by sanctions of various kinds. The terms of corporate articles of association, the standards set out in codes of practice, and the

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

contents of company law, are examples of formal institutions which are relevant to our study.

Institutions in each of the senses that we have just set out – routines, norms, and rules – do not mechanically predetermine individual choices, and they do not eliminate the central role of human agency in shaping behavioural outcomes. They do, however, have the potential to channel and influence those outcomes, which is why they merit empirical study in their own right, alongside the study of more purely behavioural traits and trends.

In the short run, institutions influence and structure behaviour, and so appear as an exogenous constraint on individuals' choices. In the longer run, however, they are the consequence of behavioural outcomes, and hence endogenous to a given societal setting (Aoki, 2010). Institutions are path-dependent, in the sense of being the result of evolutionary processes which have been shaped by particular contextual influences, possibly in contingent or accidental ways (Roe, 1996). Institutions reflect their societal contexts to a large degree, but the fit is not exact, and more formal institutions may become rigid to the point where they diverge from actual behaviour, particularly in fast-changing environments. Such a view suggests the need for an historical perspective on institutions, that is to say, one that can explain how particular institutions came to be as they are. Institutions may be the result of conjunctions of features of the economic or political environment which no longer hold, which is not to say that the institutions in question cannot be adapted to a new context.

It follows from what we have said that we should think of individuals as acting with bounded rationality and as institutions as being qualifiedly efficient. To say that individuals act with bounded rationality implies that they tend to act in an instrumental way and with the aim of improving their well-being, but in an environment which is complex and open-ended where they cannot consistently foresee the consequences of their actions (Gigerenza, 2010: ch. 1; Simon, 1955). Very often the most important information for an actor concerns what other actors are likely to do, but this information may not be readily available. In a theoretical world of fully competitive markets, such information would, by definition, be costlessly available and fully incorporated into prices. In the real world, such information is often costly to obtain, and is not always embedded in prices. Some of the information that actors need to coordinate their behaviour in complex

© in this web service Cambridge University Press www.cambridge.org

CAMBRIDGE

Cambridge University Press
978-1-107-01683-5 - Hedge Fund Activism in Japan: The Limits of Shareholder Primacy
John Buchanan, Dominic Heesang Chai and Simon Deakin
Excerpt
More information

environments is available to them through direct observation, but much more of it is embedded in institutions of different kinds. The market is one such institution, and its prices are the means by which the market conveys information of a certain kind to actors (principally, information on the preferences of other actors). The legal system is also an institution in this sense: the rules which it produces can be thought of as disseminating information concerning expectations of behaviour which are widely held in a given society and which, by virtue of their legal status, have acquired normative force. Informal institutions in the form of routines and norms perform similar functions of aiding coordination. For actors engaged in any collective social activity, including but not limited to economic exchange, accessing the information they need to coordinate their actions is a matter of interpreting their environment, and thus engaging in a search for shared meaning in objects, events, and ideas, as much as it is a question of responding in an instrumental way to signals they receive from that environment.

To say that formal institutions are qualifiedly efficient is to take the view that whatever stability or 'fitness' for their environment they may possess is contingent and contestable rather than being fixed or complete. All institutions are in a state of flux, responding mostly incrementally to shifts in their environment, but sometimes being impacted by exogenous shocks. While formal institutions reflect their environment, their separation from it, which is the precondition for their stability, is also a source of rigidities which can sometimes only be addressed through radical readjustments. To that extent, shocks are never entirely external events, but are endogenously generated whenever formal institutions cease to reflect the wider institutional environment.

The perspective we have taken on the role of institutions in responding to and, in their turn, shaping behaviour in the context of the business enterprise, has influenced the methodological choices we have made in our empirical research. A 'multi-methods approach', of the kind we have used, is appropriate for the study of societal phenomena involving complex causal processes, and in contexts where the relevant data are scarce and difficult to access (Poteete, Janssen, and Ostrom, 2010: 33). Both are the case here. To understand cause and effect in the case of hedge fund activism in the Japanese setting, it is necessary to consider several features of the institutional context of corporate governance in

© in this web service Cambridge University Press www.cambridge.org