Japanese Corporate Governance from the Perspective of Family Firms

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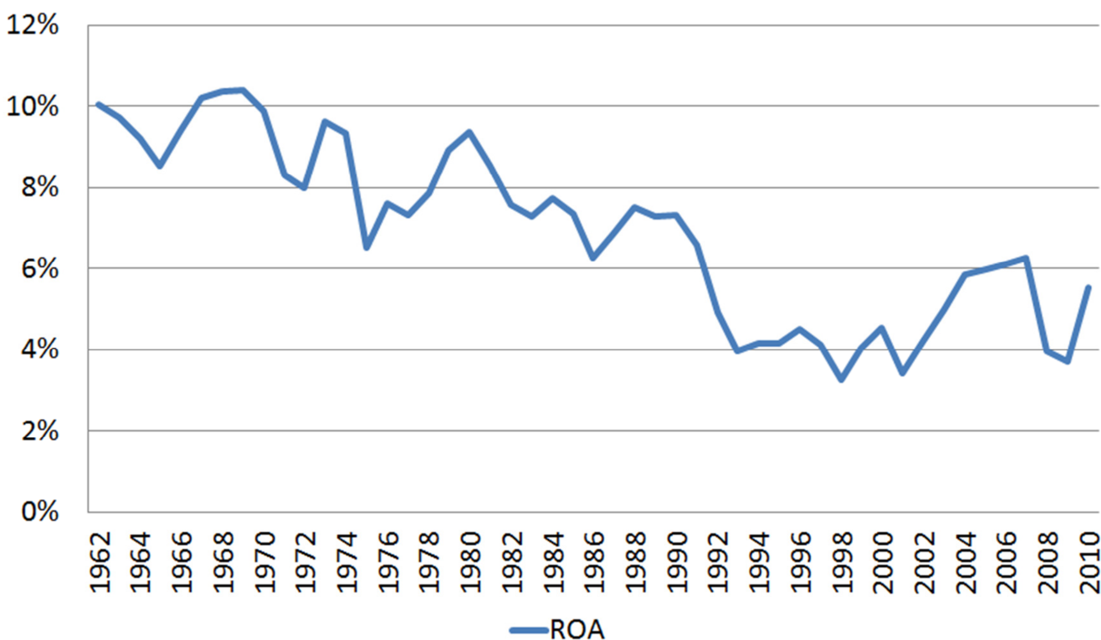
I. Introduction

Corporate governance has been a hot issue across the world, especially since the Enron scandal and the Lehman shock. The Anglo-Saxon model (A-form), which focuses on monitoring management to maximize shareholder value using hostile takeovers and outside directors, is often criticized as either malfunctioning or short-sighted.

The Japanese model (J-form) differs markedly from the Anglo-Saxon model: there is stronger capacity for internal governance, there exist mechanisms to incentivize human capital providers such as "life-time" employment, there is greater internal promotion, and shareholder intervention can be excluded through cross-shareholding. These differences were once cited to explain Japan's economic miracle, but were also cited as a major factor behind the lost decades of the 1990s and 2000s.

In fact, after the bubble economy of the mid-1980s, the ROAs of Japanese companies declined and were lower than that of Anglo-Saxon companies.

Figure 1. Historical Change of ROA of Japanese Listed Companies



* ROA is the ratio of operating income before tax and interests to book value of assets.

Interestingly, Japanese family (J-family)[1] firms have performed better than ordinary J-form firms, particularly after the economic bubble.

The objective of this paper is to answer the question: why have the performances of J-form firms been getting worse since the Japanese economic bubble in the mid-1980s, even while the performances of J-family firms have been better than that of non-family firms? This paper will then analyze the implications of comparing J-form and J-family firms on more general issues of corporate governance.

Chapter 2 will review the characteristics of J-form firms, particularly its most important aspect: internal governance. Chapter 3 will review the characteristics of A-form firms, specifically strong external governance and weak internal governance, and will draw three major distinctions between the J-form and A-form. Chapters 4 and 5 will explain how the J-family firm is unique among J-form firms: Chapter 4 will focus on its use of the internal promotion rule, and Chapter 5 will focus on its Anglo-Saxon flavors. Chapter 6 will provide statistical data on the relative ROA of J-family firms and ordinary J-form firms that will show the superior performance of the former. Chapter 7 will analyze the factors that allow J-family firms to perform better than ordinary J-form firms. Chapter 8 will conclude by drawing implications from comparing J-family and J-form firms on the issue of corporate governance.

II. The Classic J-Form and Its Strong Capacity for Internal Governance

The classic J-form was first articulated and standardized by Masahiko Aoki. While a US firm has a hierarchy of control originating with shareholders, and their management decisions are made to maximize shareholder value, the Japanese firm exhibits a non-hierarchical tendency for operational coordination, and their management decisions are subject to the dual-influence of financial and employee interests. A unique characteristic of the J-form firm is the relationship among its human capital providers, including management and employees, that we will call internal governance. In characterizing the internal governance of J-form firms, Aoki suggested that hierarchies of rank operate as the primary incentive device, which complements the non-hierarchical tendencies of operational coordination (Aoki 1990).

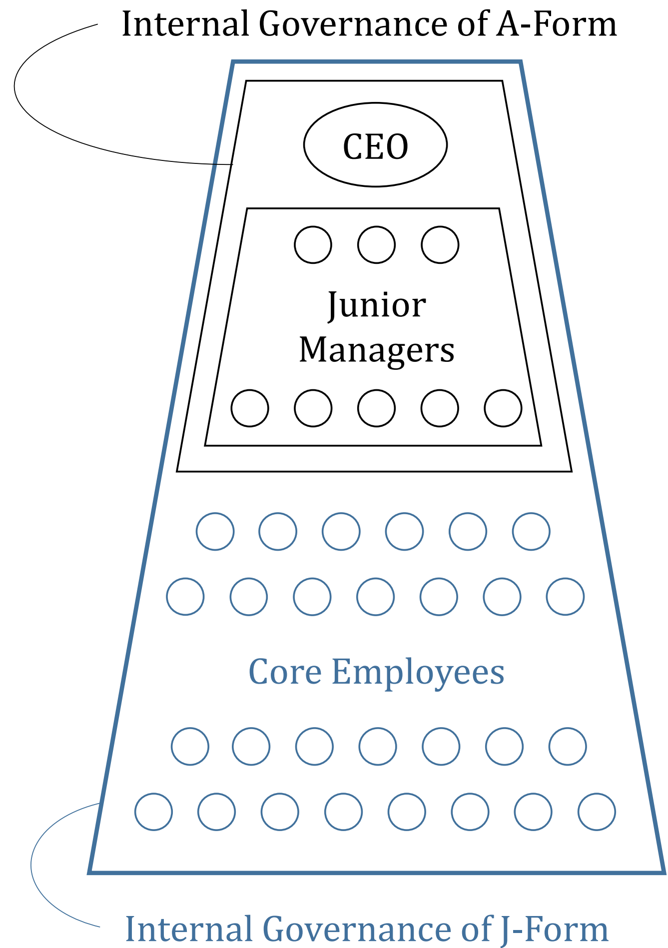
[1] We define a family firm as a listed company in which the founder or founder's heir is the senior manager (president or chairman) and/or the founding family is a top-ten shareholder.

As modeled by Acharya, et al., 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. The top manager needs to persuade junior managers that they will have a good future if they follow her. Thus, internal governance is by its nature inherently biased towards growth. Two conditions must be met for internal governance to operate effectively: there must be the prospect of a long-term career; and there must be a practice of internal promotions and long-run rewards (Acharya, et al., 2011).

According to the model of Acharya, et al., Japanese companies should typically have a greater capacity for internal governance. One explanation is that their constituents pursue long-term careers within the organization (Ono 2010). Another is that the top manager is groomed internally (Mishina & Hino 2013). And yet another explanation is that the notion of long-run rewards among constituents was established very early on beginning in the 1960s (Moriguchi & Ono 2006).

The internal governance of J-form firms can be further distinguished from that of A-form firms as the incentive bargaining takes place not only between the top manager and junior managers, but also between the top manager and all of the core employees who have the potential to become the top manager. In other words, in order to secure their long-run rewards, the core employees of J-form firms have an incentive to perform bottom-up monitoring.

Figure 2. Image of the Internal Governance of A-Form and J-Form



Such kinds of incentive mechanisms that were integrated into the internal governance of J-form firms fueled the engine of many large Japanese companies, at least during the period of high growth for the Japanese economy.

III. The Characteristics of A-Form Firms and Distinctions between the J-Form and A-Form

One defining characteristic of A-form firms is their strong external governance and weak internal governance.

Based on the agency model, shareholders (the principal) monitor management (the agent) to maximize shareholder value. Shareholder monitoring by exit or voice has been firmly developed over time. Hostile takeovers can pose a threat to management. The great majority of board seats are occupied by independent

outside directors who are expected to represent shareholder interests. Shareholder activism by institutional investors has also developed historically. The compensation packages of CEOs are often heavily weighted towards equity compensation. Thus, the strong equity incentives of top managers align with shareholder interests.

On the other hand, the internal governance of A-form firms is generally weak. With liquid external labor markets and weak employment protection laws, labor mobility is high. CEOs are not necessarily internally promoted, but are often picked from an external manager market. A-form firms thus lack the conditions for effective operation of internal governance.

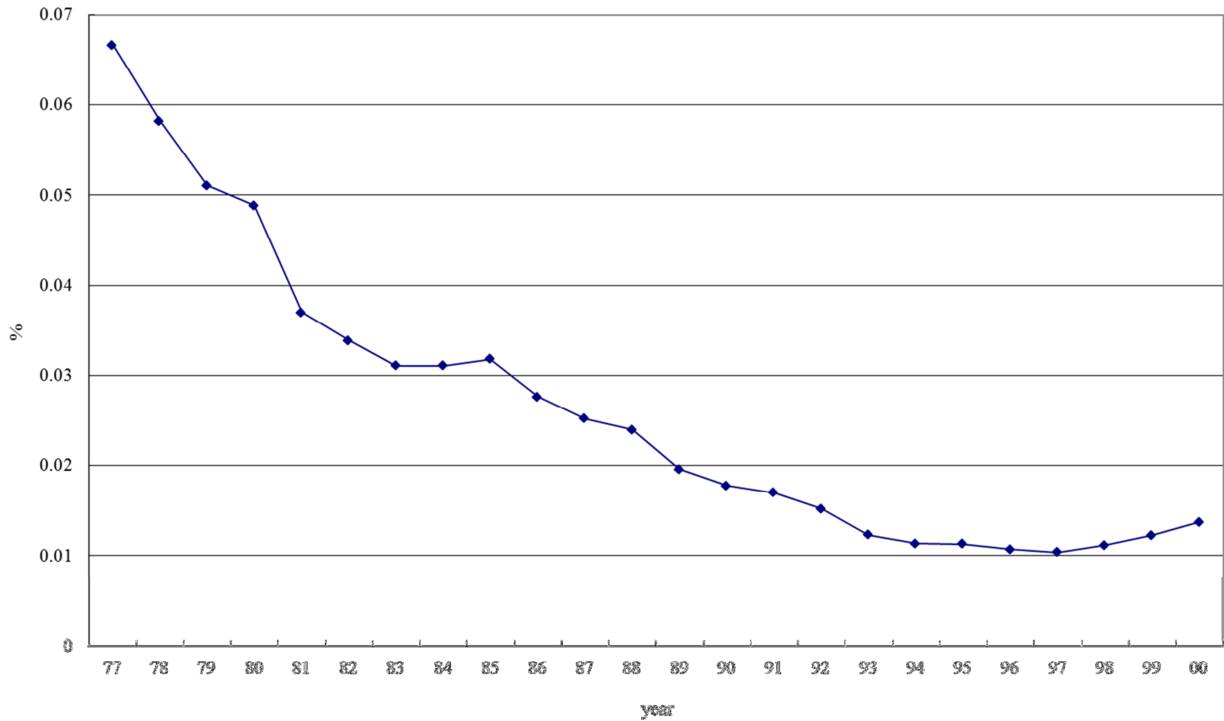
Besides their strong internal governance, J-form firms are distinct from A-form firms in three key ways.

First, the external governance of J-form firms is weaker. Although stock ownership is dispersed, Japanese listed companies tend to hold stock in each other and exchange blank proxies among each other. As a result, hostile takeover attempts have been blocked, and shareholder "voice" has been seldom exercised.[2]

Second, the equity incentive for top managers is weaker in J-form firms. Figure 3 shows the equity share of CEOs of large Japanese listed companies, which historically has decreased and is now almost negligible. Although stock options were introduced in 1997, their use has been low relative to A-form firms.

Figure 3. CEOs' Equity Share at NIKKEI 225 Firms

[2] Cross shareholding has been shrinking since 1997—the year of Japan's financial crisis—mainly because banks started to sell off their clients' stocks. Today, Japanese listed companies have dispersed into companies that dissolved their cross-shareholding and accepted stock market monitoring, or companies that still keep cross-shareholding and rely on their main banks (Miyajima and Kuroki 2007).



Third, the rate of internal promotion to the top manager position is extremely high in J-Form firms. In fact, the external market for managers is weak in Japan. Top managers at J-form firms are mostly internally-promoted, salaryman CEOs, which differs from the professional managers at A-form firms who are selected from a wide pool of candidates in a competitive external market for managers.

Table 1. Is New CEO insider or outsider?

	Insider	Outsider
US/Canada	77%	23%
Europe	75%	25%
Japan	97%	3%
Brazil/Russia/India	31%	69%

Source: Strategy& 2013 Chief Executive Study

IV. The Characteristics of J-Family Firms: the Internal Promotion Rule

The internal governance of J-family firms shares all of the characteristics of that of J-form firms with one important exception: the top manager of J-family firms are not internally promoted, and instead obtain their position as a member of the founding family or by coming from outside of the firm (typically as a son-in-law). At J-family firms, internal promotions typically reach a ceiling at the No. 2 management position.

This ex ante premise of a cap on promotions at the No. 2 position should in theory weaken the incentive of core employees to compete in the rank hierarchy, which has been an important engine for large Japanese firms. Although the J-family internal promotion rule sacrifices some of the positive energy among the core employees, J-family firms still maintain a fundamental aspect of internal governance. Core employees of J-family firms still have an incentive to perform bottom-up monitoring in order to secure their long-term rewards, even with a lower promotion ceiling and maximum reward than in ordinary J-form firms, and thus they push the top manager to pursue the continuity of the firm, *i.e.*, to maximize the long-term firm value. Therefore, a core mechanism of internal governance is still effective in J-family firms.

This internal promotion rule at J-family firms makes possible practices that are hard to accomplish at non-family firms, as explained in the next chapter.

V. The Characteristics of J-Family Firms: Anglo-Saxon Flavors

Interestingly, we observe three Anglo-Saxon flavors in J-family firms, which do not exist at ordinary J-form firms.

First, external governance works effectively in J-family firms. The stock ownership of founding families in their J-family firms is generally small—seldom more than the majority—but still substantial in most cases (See Table 2).[3]

[3] The average founding family ownership of heir-run firms is approximately 15 percent.

Table 2. Founder Family Ownership and Management

Family ownership	Family management					
	FOUNDER	BLOOD	NON-BLOOD	SALARYMAN	NON-FAMILY	sum
=0%	5	87	8	.	1,058	1,158
>0%, <5%	15	75	5	92	.	187
>=5%, <20%	53	190	21	112	.	376
>=20%, <50%	146	167	11	46	.	370
>=50%	50	17	3	4	.	74
sum	269	536	48	254	1,058	2,165
Average family ownership	32.359%	16.524%	16.538%	12.217%	.	9.912%

Founding families have both the incentive and information to monitor the firm as block holders, similar to institutional investors.

Second, top managers at J-family firms continue to have strong incentives of equity, *i.e.*, heirs manage and own a substantial share of the firm; meanwhile, at non-family firms, their salaryman CEOs rarely have substantial incentives of equity.

Another distinction that will affect a CEO's incentives is the varying length of CEO tenures, although this is not necessarily an Anglo-Saxon flavor. CEO tenure is generally longer at J-family firms than at ordinary J-form firms. While the average tenure of a salaryman CEO at J-form firms is approximately five years, the average tenure of an heir CEO at J-family firms is greater than ten years (see Table 3).

Table 3. CEO Tenure

Panel.A CEO (president) tenure			
	Obs.	Mean	Median
All CEO	10,177	8.351	5
Founder CEO	805	24.811	26
Blood heir CEO	1,150	15.278	13
Non-blood heir CEO	145	13.724	11
Salaryman CEO (non-subsidiary firm)	1,377	5.163	4
Salaryman CEO (subsidiary firm)	47	5.170	3
Non-family CEO(non-subsidiary firm)	5,732	5.868	5
Non-family CEO(subsidiary firm)	921	4.855	4
Panel.B T-test			
(Null hypothesis)			
Blood heir CEO = Non-blood heir CEO	t-value	1.640	
Blood heir CEO = Salaryman CEO	t-value	31.449***	
Non-blood heir CEO = Salaryman CEO	t-value	18.374***	

Longer CEO tenures do not matter to core employees of J-family firms because they will not be the CEO in any event; at a non-family firm, a CEO tenure of ten years or greater will effectively eliminate the chance to become CEO for core employees in the same or near generations as the new CEO. The worst-case scenario is that the best and brightest employees in these generations quit the company.

Third, J-family firms occasionally use external manager markets, typically through the system of adopted sons-in-law. J-family firms can pick talented top managers from outside of the firm without disturbing their internal governance because their internal promotion rule will not be breached. In contrast, in non-family firms, picking the CEO from outside the firm will distort the incentives for core employees. The son-in-law CEO system may work as a substitute for the external manager market.[4]

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[4] Mehrotra, Morck, Shim, and Witwattanakantang hypothesize that the unique Japanese system of adopted son-in-law CEOs is the reason why J-family firms run by heirs perform better than non-family firms. They suggest that the adopted son-in-law CEO system acts not only as a threat to biological sons, similar to a hostile takeover, but also as a prize for employees (Mehrotra, et al., 2013). While it is possible that the former is true, it is likely that the latter is not. We have not found

VI. Performance of J-Family Firms

It is not a surprise that founder-run firms perform well because these founders are the ones who themselves developed their companies into listed companies, and thus they are usually superb managers. As Table 4 shows, even after succession, J-family firms run by biological sons have performed better than non-family firms based on ROA, especially after the Japanese economic bubble.

Burkart, Panunzi, and Shleifer (2003) assumed that "a professional is a better manager than the heir." Villalonga and Amit (2006) examined the relationship between family firms and Tobin's q in the US. They concluded that founder-CEO firms outperformed non-family firms; however, when descendants served as CEOs, firm value was destroyed. Morck et al. (2000) found that in Canada, family firms controlled by an heir exhibited poor financial performance. Bloom and Van Reenen (2007) found that in France, Germany, the UK, and the US, poor management practices were more prevalent in family firms managed by a founder's descendant.[5]

Table 4 shows that during the period of economic growth from 1962 to 1985, there were not any statistically significant differences in ROA between ordinary J-form firms and J-family firms, with the exception of founder-run firms. It is only after the end of Japan's period of economic growth that the performance of J-family firms run by biological sons overtook that of ordinary J-form firms.

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a case where a son-in-law CEO was selected from among core employees; instead, they have almost always been selected from outside the firm, such as from the government or banks. If a son-in-law CEO is picked from inside the firm, the promotion rule of J-family firms would be breached and the incentive of core employees would be distorted. While the threat effect cannot be denied, the system is more likely to function as a substitute for the external manager market.

[5] A notable exception is the research by Sraer and Thesmar (2007), who found a premium for family firms in France, even if they were managed by descendants of founders.

Table 4. J-Family Firms and ROA

Dependent variable=	ROA				
Model=	pooled OLS				
	'62-10	'62-85	'86-92	'93-00	'01-10
	(1)	(2)	(3)	(4)	(5)
FOUNDER	0.016***	0.009***	0.011***	0.021***	0.026***
	(0.001)	(0.002)	(0.002)	(0.002)	(0.003)
BLOOD	0.003***	0.000	0.004***	0.006***	0.004**
	(0.001)	(0.002)	(0.001)	(0.001)	(0.002)
NON-BLOOD	0.004*	0.004	0.001	0.003	0.007*
	(0.002)	(0.003)	(0.003)	(0.003)	(0.004)
SALARYMAN	0.002	-0.002	0.003	0.005**	0.004
	(0.001)	(0.002)	(0.003)	(0.002)	(0.002)
Control Variables	Yes	Yes	Yes	Yes	Yes
Industry dummy	Yes	Yes	Yes	Yes	Yes
Year dummy	Yes	Yes	Yes	Yes	Yes
Sample Size	86,724	32,349	12,987	18,173	23,215
Adj. R^2	0.349	0.306	0.286	0.296	0.248

VII. Analysis

J-form firms performed well during the period of high economic growth but have performed poorly after the Japanese economic bubble, or in other words, after Japanese economic growth came to a halt. Within J-form firms, J-family firms have performed relatively better than non-family firms during this period of low growth.

Although J-Form firms benefit from their strong capacity for internal governance, derived from all of their core employees, this is not enough for business corporations to perform efficiently, particularly during a period of low growth.

While internal governance may serve as the engine, external governance serves as the gas and brakes. In order to complement internal governance, external governance should not be excessive (Acharia, et al.). External governance of J-form firms has historically never been excessive and this encouraged the rapid growth of Japanese companies until the mid-1980s. Following the Japanese economic bubble, the growth of Japanese companies stopped. External governance had never before operated as the brakes against a bias for growth strategies arising from internal

governance, and as such, external governance was not able to stop the waste of free cash flow. It became obvious that external governance of J-form firms was weak.

Internal governance and external governance need to work in complement. In most J-family firms, the founding family plays an important monitoring role as a block shareholder. We hypothesize that one reason for the good ROA performance of J-family firms after the economic bubble was that their external governance operated effectively as brakes on growth bias.

Heir CEOs of J-family firms have strong incentives of equity that align with the incentives of shareholders. Top managers with strong incentives of equity are more likely to avoid wasteful investment when growth opportunity is limited.

Additionally, the longer tenure of heir CEOs may give them an incentive to manage their companies from a long-term perspective. In other words, longer tenures may prevent heir CEOs from becoming myopic, typically during a bubble economy.[6]

During the period of growth, the incentivizing effect of rank hierarchies within the internal governance arrangement was greater than the benefit of picking talented managers from an external market. Put simply, there was a trade-off between these two effects. After growth opportunities decreased, the incentivizing effect of rank hierarchies became weaker and the benefit of using the external manager market became relatively greater. Especially after the economic bubble, the capacity of J-family firms to use an external manager market may have been a great advantage over non-family firms.

VIII. Conclusion

The rise and fall of J-form firms reveals a lot about corporate governance, especially when we give attention to J-family firms.

The strong internal governance of J-form firms not only provides an advantage over A-form firms, but it also raises serious trade-off problems. J-family firms are better able to compromise the trade-off.

While keeping the core element of J-form internal governance, J-family firms incorporate three elements of A-form corporate governance: shareholder monitoring,

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[6] Anecdotal evidence suggests that J-family firms were generally less active than ordinary J-form firms in investing their free cash-flow into stocks and real estate during the Japanese bubble.

equity incentives of CEOs, and use of the external manager market.[7] In other words, J-family firms are a hybrid of the J-form and A-form. This hybrid has been performing better than the genuine J-form since the end of Japanese economic growth in the mid-1980s.

The degree of hybrid characteristics taken from the J-form and A-form will be determined by the balance of internal governance and external governance. The optimal balance will depend on markets (product, capital, and labor), social norms (maximizing shareholder interest, or balancing stakeholder interests), and laws (employment protection and investor protection). Certainly, one model will not fit all.

Finally, one policy to consider in reforming Japanese corporate governance is to give CEOs stronger incentives of equity that will not necessarily induce a trade-off with strong internal governance. The legislature should fix tax law barriers that discourage J-form firms from offering greater equity compensation to their CEOs.

[7] In addition, they offer long tenures to heir CEOs. Although there is disagreement about the optimal tenure of CEOs, the practice and good performance of J-family firms might contribute to arguments for short-term and long-term perspectives of management.

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