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A recall for Toyota's corporate governance?

By Michael W. Stocker and Yoko Goto

The epic scandal wracking Toyota Motor Corp. will play a major role in influencing the international and domestic debate on corporate governance for years to come. As evidence continues to mount that Toyota's management had long failed to address potentially deadly manufacturing defects in the company's automobiles, serious questions have been raised about whether the absence of independent directors on Toyota's board helped foster a corporate culture of stonewalling and secrecy. Uncovering the answers to these questions is likely to benefit investors in both Japan and the United States.

Board independence has long been a contentious issue in the United States. Advocates of board independence have argued for decades that because independent directors are less subject to management influence, they provide better oversight and more accurate information for investors. Critics of the movement to bolster board independence have warned that management oversight is better left in the hands of insiders who are better informed about company operations and more capable of understanding the strategic implications of board decisions.

In the United States, 2002 and 2003 saw this tug-of-war shift sharply in favor of the reformist camp, as key corporate governance measures were introduced by legislators and regulators. The Sarbanes-Oxley Act of 2002 required that the audit committees of publicly traded companies consist of people with no company affiliation, minimizing management influence over the monitoring of internal controls. In November 2003, the SEC approved sweeping rules on corporate governance that required, among other things, that publicly traded companies ensure a majority of the members on their boards of directors be independent — that is, have no material relationship with the company.

Many investors are unaware that these reforms did not affect many large foreign companies whose American depository receipts are traded on U.S. exchanges. U.S. regulations provide for a "home-country exemption" that permits certain foreign companies to follow their home-country practice in lieu of U.S. corporate governance regulations, so long as a disclosure is made to investors that the foreign standards are being followed.

In the case of companies that follow Japanese rules of corporate governance, the home-country exemption permits a radical departure from U.S. standards for board independence.

At the heart of the differences between the corporate governance regimes of Japan and the United States is the fact that in Japan, board members are responsible principally to the corporation rather than to shareholders. Indeed, in one oft-cited survey of senior managers of a sample of major Japanese corporations, only 3% of respondents saw shareholders as the principal stakeholders in the corporations (Masaru Yoshimori, "Whose Company Is It? The Concept of the

Corporation in Japan and the West." Long Range Planning, Vol. 28, No. 4, pp. 33-44, 1995). In Japan, a correspondingly greater importance is placed on the boards' responsibilities to employees and other corporate stakeholders, including creditors.

As a result, corporations operating under the traditional Japanese governance regime avoid the election of board members who lack operational experience. Boards are instead composed almost exclusively of company employees and managers. As Toyota explained in a recent corporate filing, "We believe that it is important to elect individuals that comprehend and engage in (Toyota's) strengths, including commitment to manufacturing, with an emphasis on frontline operations and problem-solving based on the actual situation on the site."

For years, Toyota's remarkable success story made the company something of a poster child for the traditional Japanese approach to corporate governance, and with good reason. The company consistently outperformed other major automobile manufacturers throughout the '80s and '90s, and the company's employees, officers and board were strongly cohesive. However, this lack of dissenting opinion had a dark side.

Long before the recall scandal erupted, scholars of Japanese corporate governance warned that a frailty of the traditional Japanese corporate governance practices was a lack of management accountability and an endemic unwillingness to confront and resolve problems (Zenichi Shishido, "Significance of Board of Directors in Corporate Governance," Ministry of Finance Policy Research Institute Financial Review, December 2003).

The unfolding crisis at Toyota bears many of the hallmarks of poor board oversight of corporate management. As executives of the company have now conceded in congressional hearings, Toyota waited far too long to address serious safety concerns giving rise to the recalls of 2009 and 2010, at least in part because of poor communication about the problems within the company. The presence of independent directors on Toyota's board might have helped the company confront information that was valuable to shareholders but potentially embarrassing to corporate management.

This new spotlight on the value of independent directors should not only prompt a re-examination of corporate governance in Japan, but bolster support in the United States for measures strengthening shareholder influence on corporate boards, such as the proxy access rule proposed by the Securities and Exchange Commission. ■

Michael W. Stocker is an attorney with Labaton Sucharow LLP, a New York-based firm specializing in securities class-action litigation. Yoko Goto is an associate with the firm.