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Promotion of Employee Participation in Corporate Governance in Japan through Institutionalizing the Supervisory Board: Implications and Lessons from German Experience

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Increasing Emphasis on Surveillance among Anglo-American Boards of Directors

In the past decade, Japan has implemented reforms of its economy after the Anglo-American model with less attention to the Continental European model. From the viewpoint of corporate governance in effectively checking abuses by management, the German corporate system may have some advantage in that it has a unique system for employees' participation in corporate management.

In a general classification, corporate systems can be divided either into the single-tier Anglo-American model, where the board of directors plays the dual roles of execution and surveillance, and the two-tier German model, where the supervisory board plays the function of corporate surveillance while the board of directors is responsible for execution. It is, however, worth noting that, in order to ensure corporate governance, the Anglo-American type has increasingly been emphasizing the surveillance role of the board of directors through various measures including the requirement of a board majority of independent directors (in the UK, non-executive directors) who share no interest with management. Thus, the board of directors in the Anglo-American corporate structure has been bearing more resemblance in function to the supervisory board in Germany.

Half of the Supervisory Board Held by Employees

Anglo-American and German structures most principally differ in the fact that the half of the supervisory board in the latter is held by employee representatives. This employee participation is stipulated in and established by German co-determination law.

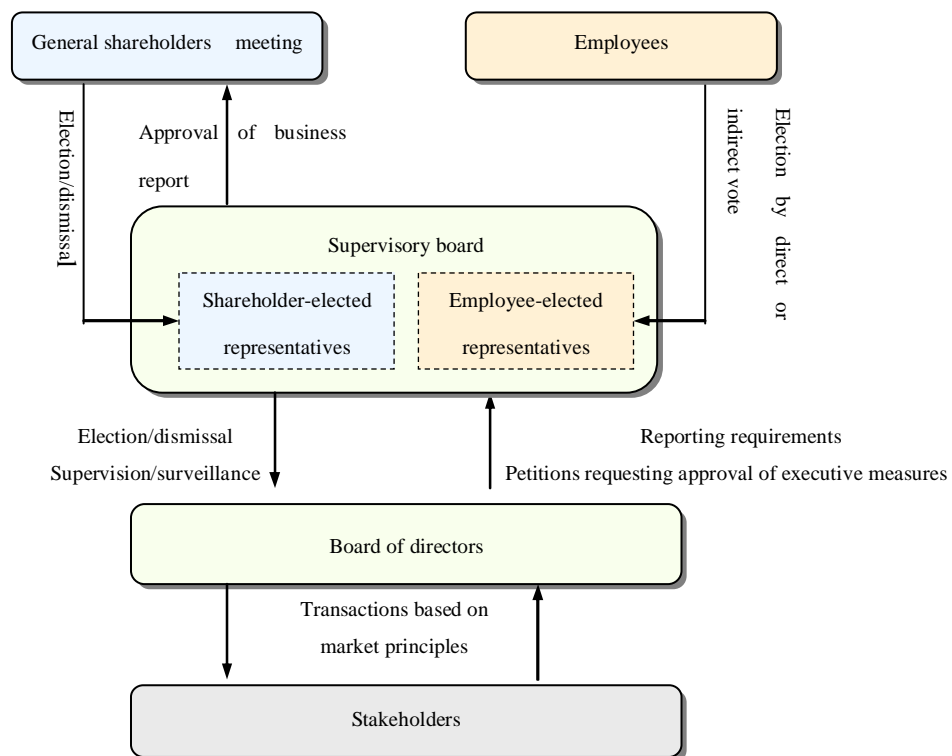
The legislation has its root in the Weimar Constitution adopted in 1919, which, based on a social-democratic ideology, introduced limitation on private property rights and provided for the social rights and right to life of its people. Article 165 of the Constitution proclaimed that waged workers and salaried staff were to be given parity with employers in deciding wages and working conditions and to be given a full say in deciding overall economic development. The Works Councils Act of 1920 stipulated that corporations with at least twenty employees should establish a works council

composed of delegates elected at workplaces, which confer with management on the execution of corporate objectives. In 1922, the law was amended to grant works councils representation of one or two of their members in supervisory boards of respective companies and limited participation in management decision-making. These original developments formed the basis for co-determination law.

Enter the Nazis' rule and the Weimar Constitution and The Works Councils Act were both abolished. The law, however, was revived in the form of the 1951 Coal, Iron and Steel Industry Co-determination Act (Montanmitbestimmungsgesetz). The Act was meant for coal and steel companies employing more than 1,000 employees but, in 1976, the Co-determination Act (Mitbestimmungsgesetz) covering all large corporations was enacted and is currently in effect.

In case of large-scale companies, the current framework provides for an even number of twenty delegates to be equally represented by shareholders and employees, with the former elected at the general shareholders' meeting. The employee delegates include representatives from labor unions and those selected from different levels of workers from blue-collared shop floor workers to white-collared administrative staff to managers.

German corporate structure with employee participation



Based on “KOPORETO GABANANSURON (On Corporate Governance)” by Moriaki Tuchiya and Hisakichi Okamoto, Yuhikaku and edited by the author

The Co-determination Act was originally intended to mediate potentially opposing interests of employees and employers and was strongly pro-labor. Today, it has increasingly assumed the role of supervising the corporate management, as is expected of independent directors in the US. While there is some criticism that the legislation has lost its substance with reported cases where the management entertained labor representatives, in a similar way to Japanese bureaucrats wined and dined for and by themselves, it remains to be an important measure to promote awareness of social responsibilities among corporate managers and their actions for public causes. Japan has a great deal to learn from those endeavors.

Japanese Companies Remain Weak in Supervision over Execution

Pursuant to the 2002 Commercial Code revisions, Japanese Corporations may now select between the “company-with-committees” and “company-with-auditors” structures. Very few companies including Sony, however, adopted the “company-with-committees” system and the rest remain to be “companies with auditors.”

The “company-with-auditors” system is a traditional structure since the Meiji Era, when it was modeled after the one provided under the German law. Its basic framework charges “directors” with the responsibilities for execution and “auditors” with those for supervision. This may resemble the German institution but, in fact, they are different in that both “directors” and “auditors” are elected at the general shareholders’ meeting and that “auditors” are regarded as subordinate to “directors.”

As such, the challenge has been to reform the legal system regarding corporate structure so that auditors can perform their intended duties and revisions to the Commercial Code since the 1970s have provided for measures including the delegation of greater authority to and increase in the number of auditors, and the appointment of outside auditors. There have been no changes, however, in how auditors are selected and outside auditors tend to be the last, honorary appointments for prominent people from the business and legal communities before retirement. Except for rare cases at a very limited number of companies, it is quite doubtful that the auditor-system is living up to the expectation.

What steps can then be taken to enable auditors to fully perform their roles in improving corporate governance and effectively check abuses by management? One suggestion is to follow the German example by giving representatives from different levels of employees a certain number of auditor positions and having employees elect their own delegates, instead of those elected at the general shareholders’ meeting.

As is clear from a declining organization rate, labor unions in Japan have been decreasing their presence year by year. Given this trend, some may argue that the German system would not be effective because corporate management would select

auditor candidates from various ranks at their discretion and have them nominally elected by employees. The danger certainly exists but it is still expected to show a certain level of effectiveness, when combined with the requirements for all auditors who are elected at general shareholders' meetings to be "outside" auditors with more stringent qualification standards.

The modernized Corporate Law is expected to be enacted as early as April 2006 but legislations regarding corporate structure for stock companies will remain mostly intact. From the viewpoint of corporate governance, the Japanese legal system structurally falls short in assuring supervision over execution, compared with those in the UK, the US and Germany. Therefore, it is likely a matter of time before the review of the current auditor system becomes a new mandate, along with the increased number of and stricter qualification requirements for outside directors at "companies with committees."

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