Chapter 2
The Perceived Development and Unperceived Decline of Corporate Governance in Japan

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Abstract Japanese corporate governance has strengthened over the last decade (the perceived development); however, this is only one aspect of this change. Another aspect requires some analysis to determine the essence and reality of Japanese corporate governance. I use the terms "vertical governance" and "horizontal governance" in the analysis for this paper. Vertical governance, which can be summarized as forced CEO discipline, is the dominant perspective of the current global governance debate. Horizontal governance is introduced in this paper and is a concept summarized as voluntary CEO discipline. I argue that horizontal governance has been a salient characteristic of traditional Japanese corporate systems for decades, although it is relatively new in terms of its theoretical perspective. The significant changes in Japanese corporate governance since the late 1990s have the potential to undermine the foundation of horizontal governance of Japanese firms (the unperceived decline). Caution is necessary in assuming that these changes portend improvements in overall Japanese corporate governance.

Keywords Catalyst • Horizontal governance • Mutual consideration • Self-discipline • Vertical governance

2.1 Introduction

Japanese corporate governance has changed considerably since the mid-1990s, particularly the governance by shareholders and stock markets (markets for corporate control). With the unwinding of cross shareholdings, foreign institutional investors increased their presence as major shareholders in Japanese companies, which both enabled and required these investors to actively engage in the governance of Japanese corporations. These changes in ownership structure led to

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aggressive investment fund attempts to levy hostile takeover bids with respect to certain Japanese public companies. Although almost all of the attempts were unsuccessful, the psychological impact was sufficient to make threats of TOB real and acute for corporate executives.

The last decade also witnessed advancements in the role of the board of directors in Japanese corporate governance. The 2003 Commercial Code reform presented Japanese companies with the alternative option of a US-style board. This type of board consists of three board committees: audit, nomination, and remuneration committees, each of which must be led by outside directors. Although the number of corporations that have adopted this committee system is limited, the governance-enhancing board is well established within Commercial Code (now the Companies Act).

Japanese corporate governance, therefore, has strengthened over the last decade; however, another aspect of corporate governance requires analysis to reveal the current essence and reality of Japanese corporate governance. This paper examines two aspects: vertical governance and horizontal governance. Vertical governance often prevails as the main factor in the current corporate governance debate, but I will argue that horizontal governance is the key, critical element with respect to Japanese corporate governance.

Section 2.2 introduces the concept of horizontal governance, which is minimally addressed in the ongoing corporate governance debate. Section 2.3 suggests that horizontal governance has been the typical mode of governance in the Japanese corporate system. Section 2.4 notes the significant changes in ownership and board structure characterized by strengthened vertical governance. I address the Japanese corporate governance system from the mid-1990s to present day. In the last section, I argue that current Japanese corporate governance, as mentioned in Sect. 2.4, has the potential to significantly alter the underpinnings of horizontal governance and cause an unperceived decline in the effectiveness of the nation's corporate governance.

2.2 Two Types of Corporate Governance: Vertical Governance and Horizontal Governance

I define corporate governance as the systems and processes that make CEO faithful to his duty. The goal of corporate governance is to preserve and promote appropriate CEO conduct. The CEO should strive to maintain and develop the affiliated corporation in compliance with rules and laws, without subordinating the interests of other stakeholders (including those of broader society) in favor of personal interest. Arguably, there are two different types of corporate governance. Vertical governance is the predominant perspective of the ongoing global governance debate. Textbooks, academic papers, and media articles concerning corporate governance are based on this perspective. It can be summarized as the forced discipline or involuntary control of the CEO (see Fig. 2.1). Horizontal governance,

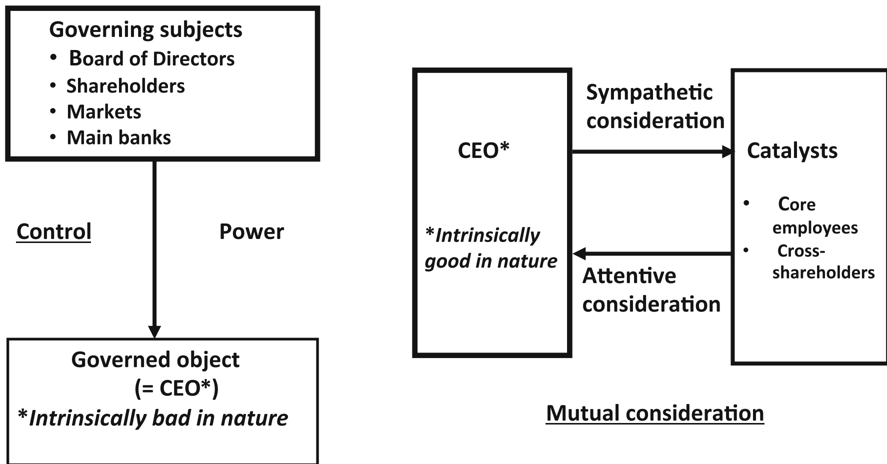

Fig. 2.1 Vertical governance vs. horizontal governance

which I introduce as a new perspective of corporate governance, can be summarized as the voluntary exercising of CEO discipline. It is relatively new in terms of its theoretical perspective; however, horizontal governance is not a new phenomenon and has existed along with vertical governance for decades. I argue that horizontal governance has long been a salient feature within traditional Japanese corporate governance.

2.2.1 Vertical Governance

The vertical governance mechanism allows governing subjects to control the governed object by exercising controlling power. Governing subjects, or governing entities, can include the board of directors, shareholders, or other stakeholders. The governed object is typically the CEO of the company. The board of directors monitors the CEO under this system and, if he fails to deliver sufficient results, the board will exercise legal punitive powers. The textbook scenario is that to avoid disciplinary measures the CEO will faithfully perform management duties.

Vertical governance is built upon two presuppositions concerning the discipline of top management: the pessimistic view of human nature (1A), and the dominance of governing subjects over governed objects (1B). Assumed under the pessimistic view of human nature is that corporate managers are selfish and unconscientious to the extent that they will pursue their own interests without regard for others and will fail to work diligently.

Dominance of governing subjects over governed objects implies that governing entities, such as boards of directors and shareholders, possess controlling power over the object of governance (the CEO) and wield unilateral power. The CEO does not possess (at least formally) the power to override the board of directors or the shareholders. The governing subjects are assumed infallible and the governed object fallible.

Presuppositions (1A) and (1B) present the traditional corporate governance model where the board and shareholders (the subjects) enforce discipline on the CEO (the object) by means of control. The "good" subjects and the "evil" object form a vertical relationship with the former situated above the latter (Fig. 2.1). The control, which ranges from introducing incentives, monitoring mechanisms, and to the firing of a CEO, is based upon the power instilled in the governing subjects.

The stronger the subject's power and the greater the likelihood of that power being exercised, the more effective (vertical) governance function will be. Therefore, recent changes to the framework and processes of Japanese corporate governance have been considered to strengthen Japanese governance. However, this opinion is the product of just one aspect of corporate governance, vertical governance.

2.2.2 *Horizontal Governance*

Horizontal governance is in sharp contrast to vertical governance. The horizontal governance mechanism allows the self-discipline of the CEO through mutual consideration between the CEO and catalysts. Catalysts refer to particular groups of stakeholders who do not possess effective or anticipated power over the CEO but, instead, inspire his sympathetic consideration.

Mutual consideration is central to this type of governance and consists of two bilateral considerations (see Fig. 2.1). The first is the sympathetic consideration by the CEO towards catalysts (which will be explained later). The CEO considers empathetically the effect of his actions on the stakeholder (i.e., catalysts). For example, the CEO might consider the stakeholders' disappointment that could result from a short-term management strategy that benefits the CEO but not the company. Alternatively, the CEO may consider the stakeholders' happiness that his management achievement might bring. Sympathetic consideration is part and parcel of horizontal governance.

However, it is unlikely that the CEO is aware of certain stakeholders that have no concern or expectations for the CEO, which highlights the second consideration—attentive consideration from catalysts towards the CEO. Catalysts should pay considerable attention to CEO actions, specifically, with respect to decision making and behavior. This attention must be free of any intention to exercise power over the CEO, which will lead to vertical governance. Attentive consideration is quite useful, and even indispensable, to the enactment and enhancement of sympathetic consideration.

Obviously, horizontal governance presuppositions are in stark contrast to vertical governance presuppositions. They are the optimistic view of human nature (2A), and the non-dominance of governing subjects over a governed object (2B). The optimistic view of human nature (presupposition (2A)) assumes that a corporate manager has a conscience and considers the interests of others, as well as the individual's own interests, without assigning higher priority to the latter. This management portrayal is not less realistic than that of the self-interested manager upon which the majority of contemporary corporate governance theories have developed. In fact, the optimistic perspective is arguably even more realistic than the assumption that corporate managers are determined to pursue their own self-interests with totally no regard to duty, unless they are monitored and controlled by others with over-ruling regulative powers.

Non-dominance (presupposition (2B)) refers to the situation where the exercising of power by the governing subjects such as the board of directors or shareholders is not anticipated even if the governing subjects do possess a degree of power over the governed object (the CEO). If a CEO considers others only by virtue of the power possessed by the governing subjects, this consideration is based on fear and not sympathetic consideration. Sympathetic consideration does not require (or is not compatible with) the power of others, but it does require the existence of attentive others as a necessary condition.

Presuppositions (2A) and (2B) suggest a horizontal relationship between the governing subjects and the CEO. Management discipline by mutual consideration, which I call horizontal governance, emerges from this relationship. In this case, it is not governing subjects who discipline the CEO. Rather, it is the CEO who exercises self-discipline that is caused by sympathetic consideration of governing subject views and emotions. However, the stakeholders who inspire CEO's sympathetic consideration are indispensable as catalysts of horizontal self-governance. Therefore, in the context of horizontal governance, they should be described as catalysts for, rather than subjects of, corporate governance.

2.2.3 The Horizontal and Vertical Governance Mix

Vertical governance has been the only perspective of the current corporate governance debate. Therefore, the nature and extent of corporate governance in a particular country is evaluated solely based on vertical governance. However, horizontal governance is also valid perspective of corporate governance.

I suggest that vertical governance and horizontal governance coexist in a widely diverse mix in every country, with the United States and (traditional) Japan as polar extremes on a continuum from vertical governance-dominance to horizontal governance-dominance (see Fig. 2.2). I argue that horizontal governance has not only existed among Japanese companies, as I will discuss in the next section, but has also been the typical mode of corporate governance in Japan. However, a CEO does not always exert sufficient self-discipline because human nature is inherently

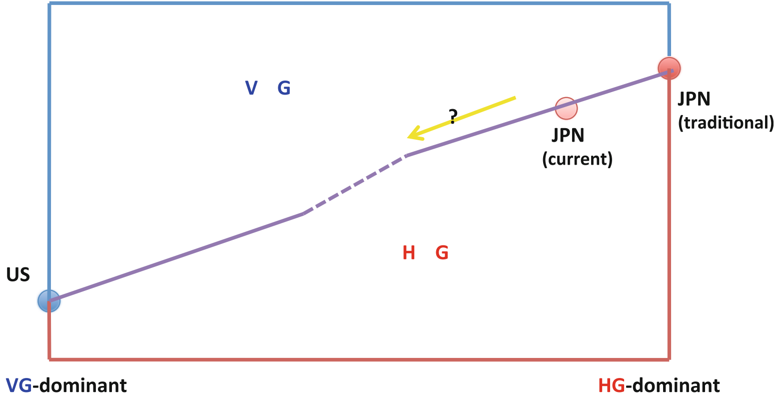

Fig. 2.2 Vertical and horizontal governance mix

weak. Thus, there are cases when the horizontally-governed, self-disciplined approach will not be effective and control-oriented vertical governance is required. However, my opinion is that such cases are more the exception rather than the rule in Japan, and it is the more typical mode of horizontal governance that I would like to address. Although horizontal governance is observed in other countries as well, it is most salient in Japan. However, with the exception of Dore (2006, 2007) and Learmount (2002), research concerning Japanese corporate governance has failed to identify horizontal governance within Japanese companies. Learmount (2002), for example, characterizes the governance of Japanese companies as "socially endogenous corporate governance" that "draws on the voluntary reciprocal obligations and responsibilities enacted in everyday individual-level and organizational-level socio-economic interactions, rather than the exercise of hierarchical controls of individual behaviour" (Learmount 2002, p. 150). This concept is consistent with horizontal governance.

2.3 Traditional Japanese Corporate Governance: The Prevalence of Horizontal Governance

Until the mid-1990s, there has been a strong likelihood that horizontal governance has been a dominant feature of Japanese companies. Although it is difficult to present direct evidence of horizontal governance, I present indirect logical evidence by demonstrating the favorable conditions that have influenced the horizontal governance function of Japanese management. Before proceeding to the discussion on Japanese pro-horizontal governance conditions, I summarize certain characteristics of ownership structure and board composition of Japanese companies.

Table 2.1 Proportion of Stable Shareholders (1990)

Stable shareholders (%)	With this number (%)
10	0.8
20	0.8
30	2.0
40	4.9
50	17.3
60	32.7
70	30.8
+	10.6

Source: Shoji Homu Kenkyu Kai (1990); cited in Learmount (2002), p. 21

Table 2.2 International comparison of common stock ownership (%)

	Japan (1994)	US (1994)	UK (1993)	Germany (1993)
Financial sector	44	45	62	29
Banks	26	3	1	14
Insurance	16	4	17	7
Funds	0	34	41	8
Others	2	4	3	0
Non-financial sector	56	55	39	72
Corporate	24	0	2	39
Individuals	24	48	18	17
Foreign	7	6	16	12
Other	1	1	3	4

Source: OECD (1996)

The ownership structure of Japanese companies has been characterized by stable shareholding or cross-shareholding.[1] Table 2.1 presents the proportion of stable shareholders in public corporations in 1990. On aggregate, approximately three quarters (74.1 %) of Japanese public corporations had a quite stable shareholding structure, with stable shareholders commanding 60 % or more of the outstanding shares. Table 2.2 shows that the majority of stable shareholders are Japanese financial institutions and other corporations with which the company conducts long-term business or financial transactions.

These stable shareholders build a long-term and closed relationship, becoming silent partners and agreeing to waive control rights and the option of selling to third parties—a system that has been criticized for engendering collusion among cross shareholding companies. Because such ownership structures significantly reduce the threat of hostile takeover bids, stock markets have not functioned as corporate governance mechanisms.

[1] I use these terms interchangeably although there is a slight difference in their meaning.

With respect to corporate board of director composition, the most notable characteristic is the virtual non-existence of outside, non-executive directors, and the subsequent domination by insiders (executive directors). The executive directors are subordinates to the CEO and, therefore, no external monitoring can be expected from them, which emasculates the board as a mechanism for checking CEO behavior.

The main banks have (allegedly) filled the void of standard corporate governance mechanisms in Japanese companies rather than shareholders, stock markets, and boards of directors. The banks are considered the effective governing subject of the Japanese corporate system based on the contingent governance mechanism (Aoki 1994). A main bank entrusts its management rights to the current executive teams of its client companies; however, it directly intervenes when performance deteriorates. Because it is credible that the corporate managers will be deprived of their management rights by a main bank if they perform poorly, discipline is maintained even when business is flourishing.

The main banks have been considered the only governing subject that exerts power over a client company in the Japanese corporate governance system. However, some empirical studies suggest that this is not the case partly because fierce competition among banks prevents them from exercising power over clients (e.g., Scher 1997; Tanaka 2002). Moreover, Learmount (2002) notes that "the relationship between a company and its main bank is not based on the power of one party over the other; on the contrary, both parties seem to be concerned with acting in ways which avoid being perceived as taking advantage of a powerful position" (Learmount 2002, p. 89).

A bank's (potential) power is compromised once companies gain their financial independence. Since the early 1980s, deregulation and internationalization of corporate finance has provided Japanese companies with increasing independence from bank loans. This has deprived main banks of any power to control and discipline Japanese companies. A main bank intervenes in the management of its client if the company is on the brink of bankruptcy. This does not mean, however, that the exercising of power by the main bank is anticipated at normal times, much less when the company enjoys financial independence. All these factors imply that main banks are not necessarily governing subjects that wield significant power over companies.

Therefore, I conclude that vertical governance mechanisms have been weak within the Japanese corporate system. Instead of vertical governance, I suggest, horizontal governance played a significant role. Horizontal governance refers to voluntary discipline through CEO sympathetic consideration; however, the CEO's recognition of attentive consideration from certain stakeholders, or catalysts, is almost indispensable to enact and enhance CEO's sympathetic consideration. From this perspective, I posit that is highly likely that horizontal governance has continuously prevailed in Japan.

The focus of my theory is the relationship between a CEO and the core employees and cross-shareholders in Japanese companies. This relationship has powerful characteristics that activate CEO sympathetic consideration for both

employees and cross-shareholders who, in turn, act as catalysts for CEO consideration. Core employees refer to managers and workers who have made a long-term commitment to work for a firm. Cross-shareholders include the main banks although they are not necessarily a governing subject.

In the context of vertical governance, employees and cross-shareholders of Japanese companies have been regarded as functionally impotent because of their lack of power over the CEO. However, ironically, horizontal governance necessitates this very lack of power on the part of the stakeholders. Additionally, both core employees and cross-shareholders possess positive, pro-horizontal governance features that encourage a CEO to sense that he is receiving attentive consideration; thus, leading the CEO towards voluntary self-discipline. Core employees and cross-shareholders are satisfactory catalysts for horizontal governance. Hence, an interesting paradox emerges from this proposition; while inside directors, who are significant core employee constituents, and cross-shareholders have been considered negative factors in vertical governance, with respect to horizontal governance they are positive, or rather decisive factors in making a CEO faithfulness to his duties and responsibilities.

There are favorable conditions for horizontal governance in the Japanese corporate system. Whereas vertical governance depends on the strength of disciplinary power that governing subjects have over a governed object, horizontal governance depends on the strength of mutual consideration between a CEO and the catalysts of governance, and particularly on the strength of CEO's sympathetic consideration. This consideration relies on the particular characteristics of the catalysts who direct their attention to the CEO. It is these characteristics that are the focal points. They include (1) the seriousness and ability of catalysts as observers, (2) the significance and unselfishness of catalysts as resource providers, and (3) the depth of the relationship of catalysts to the company (and its CEO) as stakeholders. In these three respects, core employees and cross-shareholders of Japanese firms are considered satisfying catalysts by being attentive to, and receiving sympathy (consideration) from, the CEO.

2.3.1 The Seriousness and Ability of Catalysts as Observers

The more seriously catalysts observe a CEO and the greater catalyst capability is to evaluate the CEO, the more effective their attention will be in provoking CEO sympathetic consideration. Employees and cross-shareholders in Japanese companies have been serious observers, highly capable of CEO evaluation even without associated powers of control.

Employees are committed and identify with their companies under the lifetime employment system. Employee concern with the present and future situation of their companies renders them attentive to CEO policy and behavior. Although workers and mid- and lower-level managers seldom observe the CEO directly,

they are able to know the capacity and behavior of CEO by other means. At least, formal CEO decisions are communicated to all employees.

However, informal matters such as informal CEO decisions, CEO behavior as a company leader, or personal propensity, all of which are critical factors in CEO evaluation, are not communicated formally; these information cannot be acquired unless it is gathered first hand. The majority of employees are not in a position to do so; however, a relatively large group of senior managers is. They enjoy ample opportunity to gather such information because most of them are members of the board of directors, who can observe the CEO's behavior directly, as well as operational heads of the firm's main division; although as CEO subordinates they cannot affect the CEO, it is likely that they can observe the CEO; and the evaluations made by senior managers based on such observations are easily communicated within the company through each division which they represent at board meetings. Employees are capable of evaluating the CEO also because a bottom-up decision-making procedure is a main feature of Japanese management; this procedure provides employees, particularly middle managers, with sufficient information and discernment to evaluate CEO decisions.

The essential features of cross-shareholders is that they are not only company shareholders but also business and/or financial partners. This implies that poor management on the part of the company may compound the detriment to cross-shareholders in their capacity both as shareholders and as trading partners. If shareholders only, they could sell off company shares to avoid further damage; however, this is difficult when they are also trading partners. This dual role forces them to be attentive observers of the company (and the CEO) with which they have business relationships.

In addition, cross-shareholders are superior evaluators of the company and the CEO compared to other shareholders. Daily transactions provide cross-shareholders with detailed information concerning the company. They are business specialists with business experience of their own or with business monitoring experience as a creditor. Other shareholders, such as institutional investors, are specialists in market investment but not in business management.

2.3.2 The Significance and Unseflishness of Catalyst as Resource Providers

Serious and able observers can even be more effective catalysts if they contribute resources to the company. This is particularly so when they contribute important resources in an unselfish way. The CEO is likely to feel indebted to such contributors, which will arouse his sympathetic consideration for them.

No manager would deny (at least officially) that employee contribution is essential to the firm; but in Japan, more than any other country, the idea is widely perceived, explicitly and convincingly. The active involvement of employees in

firm operation and decision-making has been a salient feature of Japanese management. The dynamic has been a source of competitive advantage for Japanese companies along with firm-specific employee investment derived from such involvement and a long-term commitment to the company.

Moreover, it is the cross-shareholders that have protected this firm-specific investment from being exploited by foreign or domestic predators.[2] Moreover, cross-shareholders are major suppliers, purchasers, and/or capital providers with whom the company maintains long-term network relationships, another key factor in the success of Japanese companies.

The resources contributed by employees and cross-shareholders are significant, and CEOs acknowledged these contributors to the extent that they feel a sense of indebtedness.

The feeling of indebtedness might be attenuated, however, if resources are provided with the sole intention of treating the company (and the CEO) as a means to maximizing resource providers' self-interest. However, this has not been the case for employees and cross-shareholders of Japanese companies. It is true and justifiable that the core employees and cross-shareholders pursued their own interests to some extent; but, in general, individuals worked or transacted for the benefit of the company that employed them and/or with which they did business, based on reciprocal responsibilities, obligations, and trust (Learmount 2002).

2.3.3 The Depth of the Relationship of Catalysts as Stakeholders

Sympathetic consideration is more evident the stronger the relationship between the parties involved. More direct, frequent, and multi-dimensional interactions concerning higher-stakes matters in the longer-term will result in deeper relationship, and deeper relationship develops mutual responsibilities to further stimulate sympathetic consideration.

Japanese management has long been noted for its long-term, relationship-oriented approach to stakeholders. A CEO aims to actively communicate with middle managers and even junior employees (for example, by holding small group meetings with middle managers and paying frequent visits to factories and other job sites). A CEO aims to communicate much more so with senior managers including the executive directors, the majority of whom have shared their working experience with the CEO as a member of the same company community.

Cross-shareholders are long-term business partners as well as long-term stable shareholders. In most cases, cross-shareholders, as business partners, interact with the company more directly, frequently, and multi-dimensionally in the longer term

[2] Managers have been aware of the importance of firm-specific investment long before the term was coined and disseminated by academics.

than other shareholders. Therefore, the company's relationship (and top management's relationship) with cross-shareholders is stronger than the company relationship with other shareholders including institutional investors.

These various characteristics of Japanese employees and cross-shareholders have been critically regarded as preventing CEO discipline by an outside body. Hence, these characteristics impede vertical governance through control. Alternatively, these characteristics facilitate horizontal governance through mutual consideration.

2.4 The Current Japanese Corporate Governance System: Strengthening Vertical Governance

Amidst worldwide concern with corporate governance since the mid-1990s, when successive corporate scandals plagued the country, the lack of corporate governance became a popular issue in Japan. Ailing corporate performance in the post bubble economy was also ascribed partly to governance deficiencies. Japanese corporate governance has evolved in a new direction, a direction towards the establishment of effective governance. It was construed as "[to] realize a form of corporate governance that meets global standards" (Keidanren 1997), which in effect were Anglo-American standards, utilizing a board of directors, shareholders, and the stock market to sufficiently play their roles as corporate governing subjects that discipline the CEO. Emphasized were the control by shareholders and the market (empowerment of shareholder rights and the promotion of market discipline) and the greater role of board monitoring.

First, the control by shareholders and the market has been strengthened. Substantial change in ownership structure has occurred, and an increase in foreign institutional ownership and an unwinding of cross-shareholding have developed concurrently.

Figure 2.3 shows the long-term trend of all Japanese listed firm ownership structures. The ratio of foreign ownership, the majority of whom are foreign institutional investors, soared from 4 % in 1990 to 26 % in 2007, replacing domestic financial institutions as the largest category. Ownership by financial institutions, and banks in particular, dropped significantly. Banks sold their corporate shares partly because of the need to satisfy the BIS (Bank for International Settlements) rule and the introduction of current value accounting in Japan. The unloading of corporate shares by financial institutions caused a decline in the stable shareholder ratio from 45 % in the early 1990s to 27.1 % in 2002 (NLI Research Institute 2004; Miyajima and Kuroki 2007).

These changes brought two pressures that intensified vertical governance. First, there is intensified pressure from shareholders. Large institutional shareholders, particularly foreign shareholders, demand higher returns on their investments (dividend increases and share buy-backs, for example) and enhanced corporate

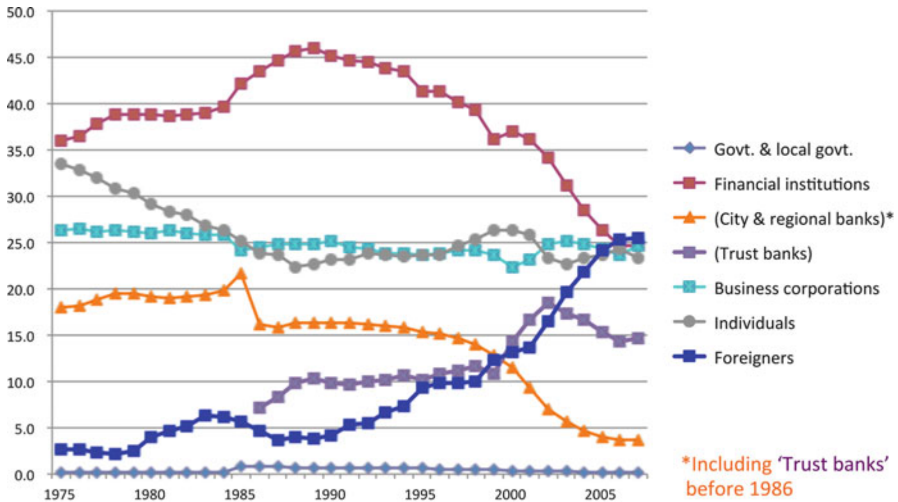

Fig. 2.3 Long-term trends in ownership structure of Japanese listed firms (%). Source: All Domestic Stock Exchanges in Japan (2007)

governance within the firms with which they invest. This behavior is in contrast to stable shareholders who would not make such demands. These shareholder demands are conducted at IR meetings or other informal meetings as well as at the annual general meeting. Such demands—or even the possibility of these demands—by shareholders, alongside continued CEO monitoring, can function as the voice mechanism (Hirschman 1970) to enforce management discipline.

Another pressure that surfaced from ownership structure changes was intensified pressure from the market. Foreign institutional investors, unlike conventional cross shareholders, will not hesitate to sell their shares to a takeover bidder who offers a premium price. The rise in foreign ownership, therefore, posed the extensive threat of hostile takeover bids in Japan for the first time since the early 1970s (when the liberalization of the Japanese capital markets began). This led to executive sensitivity with respect to company share prices. To some extent, the exit mechanism of the stock market became effective. Because the threat of hostile takeovers has yet to be imminent for the majority of Japanese companies, the market pressure seems to have remained in a potential state. However, Japanese corporate executives are sensitive to their own company's share price as a result of recent, sporadic occurrence of hostile takeover bids, coupled with intensified shareholder pressure, which was not the case 10 or 20 years ago.

Second, with respect to the boards of directors, corporate governance reform, or board reform, has steadily increased among Japanese companies since 1997 when Sony first initiated its own reforms. Full reform consists of (a) introducing an executive officer system, (b) reducing the size of boards, and (c) increasing outside directors, as was the case in Sony's reforms. Many companies that followed suit put both the introduction of the executive officer system and the reduction in the size of boards into practice, aiming, allegedly, at speeding up decision-making and

enhancing the integrity of each business unit. The majority, however, stopped short of the full scale introduction of external directors, which would have tightened external supervision of top management.

However, the full reform of boards of directors has been introduced in the law as an option. An amendment to the Commercial Code in 2002 introduced a new governance structure called the "company with committees" system. Under this new American-style structure, it is required that (1) a board possess three committees (for audit, appointments, and compensation), all of which are made up of a majority of outside directors and that (2) executive officers, as well as a board of directors, be established. This structure, however, is a second option alongside the conventional option allowed by law. Companies are permitted to opt for this new model in place of the traditional "company with the auditors" system. However, the ratio of the Tokyo Stock Exchange firms that have adopted this new structure is confined to only 2 %. Notwithstanding, the fact should not be underestimated that the governance-enhancing board was well-institutionalized in the Japanese Companies Act and an increasing number of companies that have retained the traditional board structure are now choosing to introduce outside, non-executive directors (the ratio of Tokyo Stock Exchange First Section firms that have one or more external directors rose from 30 % in 2003 to 45 % in 2007). External supervision is becoming more widespread and tolerated in Japan (Buchanan and Deakin 2007).

In sum, the standard corporate governance mechanisms have arisen in recent years whereby shareholders, stock markets, and boards of directors play certain roles (potentially at least) in enforcing CEO discipline.

2.5 Horizontal Governance in Decline?: The Outcomes of the Recent Emphasis on Vertical Governance

The significant change in Japanese corporate governance towards enhanced vertical governance that began in the late 1990s has the (logical but fair) potential to undermine the foundation of Japanese firm horizontal governance. Foreign or domestic institutional investors and external directors engage in CEO discipline using power that is based on the presuppositions of a pessimistic view of human nature (1A), and dominance of the governing subject over a governed object (1B). This leaves little room for mutual consideration. The CEO is expected to deliver good business results that are objective and easily perceived. Unperceived and subjective benefits, such as sympathetic consideration, are not expected from a CEO by institutional investors and external directors. Foreign or domestic institutional investors who seek corporate control within the marketplace are not interested in mutual consideration at all. Consequently, CEOs are concerned more with exhibiting positive business results and less with consideration and voluntary discipline, which can lead to unfaithfulness to their duties without the external control of others. An excess of emphasis on vertical governance may cause (or may

have begun to cause) fundamental damage to horizontal governance that has so far functioned well in Japan.

The complementary balance between the vertical and horizontal governance modes is delicate. They have coexisted for years in Japanese corporate governance, with horizontal governance presiding over vertical governance, and vertical governance being mobilized only in exceptional cases. However, horizontal governance is intrinsically vulnerable to vertical governance. Although it is unlikely that corporate practices will undergo such extreme change that would cause vertical governance to dominate horizontal governance, it is possible that people's perceptions about CEO discipline could shift radically in favor of vertical governance. A demand for intensified vertical governance that dismisses horizontal governance as either irrelevant or naïve, could cause horizontal governance to steadily give way to vertical governance.

There exists a kind of asymmetry between these two modes of governance in that they can easily coexist as long as horizontal governance prevails, but not necessarily when vertical governance dominates. One reason for the asymmetry is that vertical governance is supported by the coercive powers of legal oversight and its institutional foundations, whereas horizontal governance relies solely on, and is supported by, informal interactions among the parties involved.

The second reason for the asymmetry is that vertical governance can produce demonstrable evidence, for example, the findings of introduced outside directors, regardless of their effectiveness in monitoring the CEO. However, with respect to horizontal governance, it would be impossible to produce direct evidence. The CEO inculcates self-discipline through horizontal governance using introspective reflection from mutual consideration with catalysts.

The third reason is as follows: if the overall consensus in society is in favor of horizontal governance, this consensus will become socially binding, holding CEO executives responsible for the faithful execution of their duties; however, if the overall social consensus is in favor of vertical governance, it may release CEOs from the faithful execution of duty because the presumptions of vertical governance provide a convenient excuse for misconduct. Therefore, it is likely that they will behave exactly as the presumptions predict (Ghoshal and Moran (2006) call this a self-fulfilling prophecy). Individuals will demand intensified vertical governance, relegating more socially acceptable horizontal governance as irrelevant or naïve. Should this occur, caution is required in suggesting that the ownership and board structure changes of Japanese corporations over the past decade are changes that have improved overall Japanese corporate governance.

While the quality of vertical governance can be improved by change in ownership and board structure, the quality of horizontal governance in Japan can and will deteriorate as a result of change in ownership and board structure. An overdependence on vertical governance is not productive, as the global and particularly US experience has shown, partly because it results in a vicious circle of corporate scandal and tightened regulation. Therefore, caution and skepticism is required concerning the unintended consequences of allowing vertical governance to supersede horizontal governance within Japan corporations.

With respect to the Japanese corporate system, I suggest the harmonious coexistence of horizontal and vertical governance, where horizontal governance is proactively emphasized. To create such a coexistence, more emphasis must be given to horizontal rather than vertical governance. Considerable care and maintenance is required to prevent horizontal governance from being overwhelmed by the current, twenty-first century tide of vertical governance. The reinforcement of mutual consideration is significant. The conceptual framework for horizontal governance (see Fig. 2.1) implies that both parties involved in mutual consideration are pertinent; however, I suggest that consideration by the CEO is much more essential.

The critical issue is the moral edification of incumbent and future corporate executives. Since the end of World War II, Japanese society has ignored the notion of moral edification. However, I believe this is exactly what Japanese business education should reemphasize and commit to. Moral edification is the key to realizing a harmonious coexistence between horizontal and vertical governance. This commitment would lead to a more desirable and humane form of Japanese corporate governance, which will promote sound and vigorous corporate activity and economic and social prosperity.

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