The Role of Outside Directors in Improving Japanese Corporate Governance

Dissertation Evaluation for DBA Candidate, Hitoshi Tsuboi

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Overview: Hitoshi Tsuboi frames his thesis around several research questions. Why do Japanese listed firms need outside directors? In what situations do outside directors contribute to a firm? What role do outside directors contribute to a firm? These appear to be very simple questions, and they have been addressed in the Japanese context. In his thesis, however, Tsuboi examines these questions from a much richer and diverse theoretical perspective, presents quantitative analysis on the effect of directors on performance under different conditions and offers some very interesting qualitative material on what directors actually do. Additionally, he integrates insights from cognitive psychology to provide a new perspective on the contribution of outside directors, which holds promise not only for scholars in corporate governance but for practitioners.

Chapter 1 is a review of the problem and the research questions. Tsuboi provides an overview of the issue of low performance in terms of ROE and EVA of Japanese firms and attributes this to poor corporate governance. He then offers an overview of the research approach to determining causes of and solutions for this governance problem, particularly with reference to boards of directors. **Chapter 2** is a summary of corporate governance in Japan. It highlights two stages in recent history, the bank-centered model before the bubble economy, and a subsequent towards unwinding of cross-shareholding and increase in foreign investors. This is a thorough review of the history of corporate governance in Japan and major developments, which cites the major literature in this area.

In **Chapter 3,** Tsuboi assesses Japanese corporate governance from diverse theoretical lenses. He makes the important point that while studies of corporate governance have been dominated by agency theory, there are other perspectives that can be either complements or substitutes to agency theory. He examines Japanese corporate governance not only through agency theory, but also through stewardship theory, bundles theory, and resource dependence theory. This is a very useful contribution to literature on Japanese corporate governance, which usually looks at the Japanese system either in terms of agency theory or a "unique Japanese model" rather than some of these other prominent theory. Tsuboi demonstrates how existing corporate governance practices in Japan diverge not only from agency theory, but also from stewardship theory and resource dependence theory. His is the first application that I know of the recently popular bundles theory to Japanese governance. In summary, he argues that the monitoring role of the board is of the utmost importance in Japan, and that boards in Japan are generally weak in this area.

In Chapter 4, Tsuboi presents case studies of the governance of three prominent companies. He combines interviews with investigation of relevant articles from the business literature. As he was looking for best practices, he selected three firms that have been evaluated as having particularly good governance. He was interested in finding out why these companies adopted governance reforms (in these cases, board with committees system, with independent directors), and his emphasis was on asking central executives involved in governance in the company, why they adopted governance reforms, and particular, how does the system of independent directors and committees actually function.

Information on how boards actually function is hard to get, and Tsuboi did a very good job to get his respondents to speak honestly and extensively on their firm's governance. He finds that there are three important components linked to the success of a governance system: motivation, design and performance. Without sufficiently strong motivation from top executives, governance will not be effective, because outside perspectives will not be used effectively, and outside directors will not receive sufficient information to make appropriate evaluations of the firm. Tsuboi's respondents told him that outside directors were particularly important when firms were at a cross-roads, and independent boards were able to set firms in a better direction. It is interesting that respondents did not see governance as having an immediate effect on performance, but rather, was important in the long term.

Based on these interviews, Tsuboi finds that the notion of "constructive interaction" developed in cognitive science, applies to the role of outside directors in these successful firms. In **Chapter 5**, Tsuboi expands this concept of constructive of interaction, and applies the work of a cognitive scientist, Miyake, to boards. Miyake studied constructive interaction in a very different setting—explaining the operation of sewing machines—and showed how an outsider with less specific information can interact constructively with the insiders who deeply understand the process, to bring deeper understanding. As Tsuboi suggests, this collaboration between insiders and outsiders on boards can lead to better outcomes, as outsiders can disrupt insiders out of their local understandings and through the tension between inside and outside perspectives reveal new understandings. The important implication is that board effectiveness is not simply the number or ratio of outside directors, but is in the nature and quality of interaction between inside and outside directors.

In Chapter 6, Tsuboi offers a quantitative analysis of the performance of firms and independent directors using Tobin's Q as a measure of performance and ratio of outside directors in a large sample of listed firms. He finds that in the case of firms performing poorly—in other words, when they are at a crossroads—and outside directors are particularly strongly associated with higher performance.

Chapter 7 ends with a discussion and conclusion, and offers implications to practitioners as well as academics on understanding the role and function of independent directors. It closes with a useful overview of recent trends in corporate governance in Japan.

Overall evaluation: The purpose of a DBA thesis is to bridge between academia and the world of practitioners, to use theory and rigorous empirical research to shed light on problems important to practitioners. This thesis fulfills this purpose very well. Tsuboi has conducted a broad and extensive survey of governance in Japan, and demonstrates a good knowledge of this literature. His empirical research is very well-executed, and he is clear about his objectives in the research and their implications. He brings in, from cognitive psychology, a newer and deeper view of a role of the independent director in constructive interaction. This boundary crossing is very creative and innovative, and ultimately, provides useful insights to researchers and practitioners in corporate governance.

As in any dissertation, there are some areas for improvements. Though the qualitative cases were very well done, a few more company cases would have been even better. He selected only best practices, but it would have been interesting to included cases of firms that did not represent best practices. Second, the thesis is rather unclear on performance outcomes. Tsuboi argues that constructive interaction will send firms in a better direction—that is not necessarily related to performance. But, what he means is not clear—if there is no performance impact at all, why have independent directors? Clearly Tsuboi, and his interviewees mean that long-term sustainable performance will be better, but as he develops this idea, he needs to work on developing this concept and its measurement. However, we think of this as a next step in the research as we feel that the contribution of the dissertation is not in the technical aspects of measuring performance, but really teasing apart and identifying a new mechanism by which governance is effective in other words, constructive interactions, and also by examining corporate governance in Japan from a multi-theoretical view. Tsuboi could also do better at bridging the notion of constructive interaction with his finding that monitoring is particularly important.

The main contribution of this thesis is in identifying a new mechanism by which outside directors are effective. Another contribution is the deep investigation of the weaknesses of corporate governance in the Japanese context through multiple theoretical perspectives, and making a very strong case on the importance of monitoring. This is very useful to practitioners who are struggling to understand why independent directors are useful, and those who are trying to set up and design boards so that they are effective.

The evaluation of the committee is that this thesis completely meets the criteria for a DBA degree offered by Hitotsubashi University Graduate School of International Corporate Strategy.

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