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Systemic Weaknesses of Japanese Relationship Capitalism: Evidence from the Case of Livedoor

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The paper aims first, to describe the basic structure of Japanese relation-based financial system and then highlights the weaknesses the system is embedded with. In so doing, we illustrate a widely cited case, Livedoor. In the lens of this illustration, we show that the financial system of Japan depends more on social practices and relation among and between groups than on formal laws and regulations. Its internal coherence acts as social lubricants for transactions and serves as a basic means of corporate finance and governance. The system however, can be squeezed by any maverick market maker. But, social norms and practices do not allow this practice to happen which can be proved from Livdoor's attempt for and ultimate failure to takeover the venerable Nippon Broadcasting System as well as the death of Livedoor itself. The study therefore, is expected to help policymakers to identify the loopholes of the system and prevent any undesirable practices.

Keywords: financial system, corporate finance, Japan, Livedoor, corporate takeover

JEL Classification: G32, G34

1. Introduction

The globalization has an important implication for financial systems in general and the evolution of corporate finance in particular. A financial system facilitates channeling funds from surplus units, usually the households, to deficit units like corporations. Fund transfers can be accomplished through some intermediaries including banks and non-banks financial institutions. This model of financial intermediation is called indirect form of financing. In contrast, fund can be channeled directly through the capital market like stock or bond market. A financial system that emphasizes on this form of financing mode is called direct financing. Suzuki (2005) states that the major difference between direct finance and indirect finance relies on who assumes the credit risk. Credit risks arise from the fact that investors (deficit units) may be unable to repay the borrowed amount or delay the payment. In the indirect financial system, banks or other financial intermediaries assume the credit risk relating to borrowing firms. For example, if a borrowed firm goes bankrupt, money deposited by households with the bank will not be directly affected. In the direct financing route, households directly assume the credit risk relating to companies that have issued the securities (stocks or bonds).

The financial system followed by the United States and UK can be termed as 'capital market financing' or 'stock market capitalism' because security markets play a very

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important role for mediating financial resources. Capital markets are functionally strong and dynamic because of the presence of large and diversified base of investors (Suzuki 2005). Moreover, shareholders rights are legally protected while the requirement for information disclosure is clearly pronounced (Shleifer and Vishny 1997). Performance of a firm is thus, believed to reflect in the stock prices. Firms that are undervalued due to managerial inefficiencies become easy prey to prospective acquirers. In such a market-driven institutional setting corporate takeover is believed to render a strong support towards monitoring borrowing firms and thereby protect the interests of a large number of small, non-controlling and dispersed shareholders (Manne 1965). Keeping this in mind, US corporate managers focus on increasing the market value of stock which sometimes makes them short-termists (O'Sullivan 2000). These predominant features of corporate behavior along with extensive role of stock market for mediating information and corporate finance characterize market oriented US system of finance and governance.

In contrast, the postwar Japan represented distinctive versions of non liberal capitalism embedded in, and managed through, its respective national institutional settings. Japanese capitalism can be viewed as the 'welfare capitalism' or a bank based system of 'relationship finance'. The system puts much emphasis on financial intermediaries particularly banks for mediating funds from savers to investors. Banks are lenders for corporations and at the same time stockholders. Therefore, they undertake monitoring activities of firms. Large stockholding of banks facilitates to establish a long-term partnership with firms. Resultantly, inter-firm transactions rely less on strict laws and regulations but more on relation and corporate tie. In this sense, trust and reputation have been transformed into a kind of self-regulating governance mechanism that attracts considerable attention for engaging in transactions. Corporate 'herd-behavior' is the safe game for players because any detour from the crowd might yield severe penalties.

Apart from these, individuals do not constitute the dominant group of shareholders but rather a lion share of stock is held by corporations and financial institutions such as banks (Prowess 1992). A Strong tie between firms and banks coupled with reciprocal shareholding weakens the push for corporate information disclosure to outsiders. As such, market price of stock is not believed to absorb true performance of firm as they are in market-based financial systems. This tradition hinders the development of an active market for corporate control. Now the question is: how much the system is protected from potential threats ensued from prospective maverick players? What happens if a player takes the advantage of loopholes involved with informal institution and how does the society react to this happening?

The paper aims to answer these questions. In so doing, it describes the nature and characteristics of Japanese relation-based capitalism and then illustrates a widely-cited case, Liveddor, to figure out if the firm resorted to any unconventional means of financing and management techniques which the society did not accept leading the firm to bankruptcy.

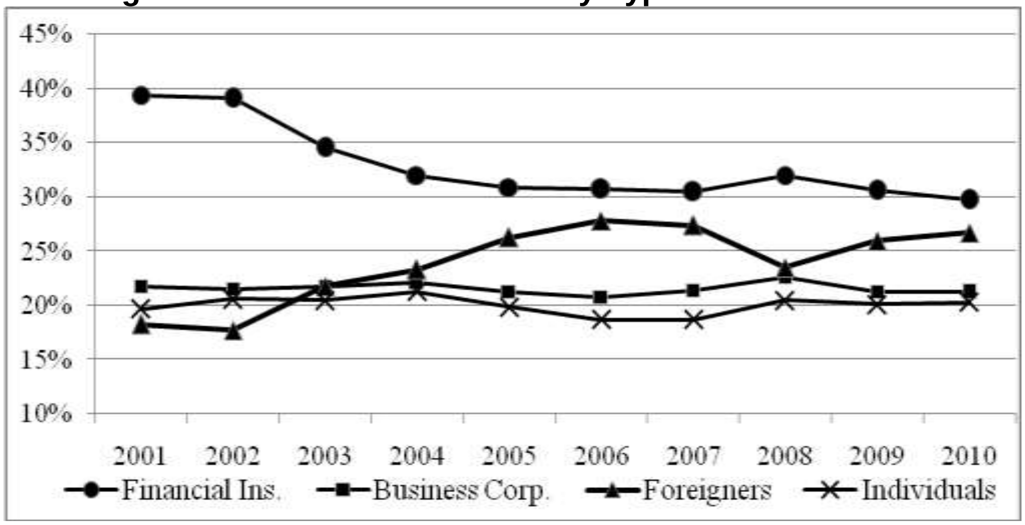
The structure of the paper is as follows: section two describes the basic characteristics of the Japanese relation-based capitalism going through existing literature. Section three illustrates the detail about the case of Livedoor highlighting its financing techniques and the reasons for its bankruptcy. Based in this case, potential weakness of the system is demystified in section four which is followed by a brief conclusion.

2. The Relation-based Capitalism of Japan

Any financial system evolves focusing on the scarcity of resources. Among others, two most important resources that a firm requires for its existence are human resources and capital or fund. Thus, the system of financing and governance evolves centering on the resource scarcity. 'Fund-scarce' model stresses that financial system should be instituted focusing on shareholders in such a way that resources supplied by them are utilized in achieving firm's objectives which is widely known as 'value maximization'. In contrast, 'labor-scarce' model implies that the focal point in an organization should be to utilize the human resources providing them with various kinds of incentives which sometimes might conflict with value maximization proposition of firms (Shishido 2000). Thus, a national system of financing and governance can be explained by shedding analytical lights on these two factors.

Like the Anglo-Saxon countries, major portion of firm's financial needs in Japan is not met by individual shareholders. It has a distinct feature of share ownership in the sense that financial institutions (mainly banks) and corporations comprise major shareowners of firms. Figure 1 shows the share ownership history of Japan. In 1990, financial institutions alone held 43 percent (in terms of market value) outstanding shares of firms listed in the Tokyo Stock Exchange (TSE). Aggregate shareholding by financial institutions and corporate investors was 73 percent (in terms of market value) which declined to 51 percent in 2010. However, the decline cannot be attributed to the rise of individual shareholdings but rather due to the emergence of foreign shareowners, which rose manifolds from 7 percent in 1985 to 27 percent in 2010. Individual shareholdings remained almost unchanged in the last few decades. For example, individuals owned 22.3 percent outstanding shares of Japanese firms in 1985, which declined to 20.3 percent in 2010. This scenario can be contrasted to that of the Anglo-Saxon countries where major shareholders are dispersed individuals (Suzuki 2011). This implies that individual shareholders do not supply major portion of funds in Japan, but corporations and financial institutions provide substantial share of firm's financing needs through shareholdings

Figure 1: Market Value Owned by Type of Shareholders



Source: Tokyo Stock Exchange

The root of corporate shareholding can be traced back to the pre-war *Zaibatsu* – closely held family corporations – which consisted of different firms including banks, trading companies, and manufacturing concerns. Major share of these *Zaibatsu* firms were held by a common holding company through head-office, which itself was controlled by a wealthy family (Flath 2005). In the postwar period, the US occupation authority, after assuming administrative power, dissolved interlocking shareholdings. However, almost all of these former *Zaibatsu* firms were widely existed in Japan in the form know as *Keiretsu,* a well-established networks of horizontally linked firms. Moreover, the bond further tightened as a defensive measure, responding to a potential threat resulting from a series of high-profile hostile takeovers raids, especially around 2000s (Morck et al. 2000). At the center of every *Keiretsu,* there is a financial institution, particularly a bank. Banks play pivotal role as lenders by providing loans to firms and also by holding shares. Consequently, the shareholding bank has enormous latitude to influence the governance systems of a firm. A specific bank works as a '*main bank'* – a single bank that caters substantial financing needs of a client firms through lending money and holding shares. There is a tightly-knit relationship between the *main bank* and the client firm in the sense that the bank sends directors to represent in the client's board and also provides necessary information for proper management in the case of crisis of the client firms. The *main bank,* also, takes part in rescue operations of firms during their financial distress (Hoshi and Kashyap 2001). Thus, information disclosure about the true performance of firms is concentrated on the *main banks'* requirements rather than on individual shareholders. The basic incentives for banks, on the other hand, is provided by the regulatory authority, specially ministry of finance (MOF), by creating rents for banks keeping deposit and lending rate below the market level (Suzuki 2011).

The system of *main bank* lending and *Keiretsu* share ownership has a great implication for the financial system in Japan. The inter-firm network system is characterized by stable shareholdings in the sense that majority shareholders are believed not to sell shares of firms belonging to the network to third parties (Gerlach 1992; Prowess 1992). When traded, they are likely to be placed with a previous shareholder, usually a

Keiretsu member. Gerlach (1992) shows that over 82 percent of the 10 largest shareholdings in Japanese firms remained stable over the period 1980-1984, as compared to only 23 percent in his US sample. This figure remained relatively stable throughout the period of 1969-1986. Nitta (2009) shows that from 1987 to 1992 cross shareholdings were strengthening. Only, the period of 1998 to 2004 saw a relative decline in the status of cross shareholding, even though the magnitude was not substantial. However, since 2005 cross shareholding has been resurging among corporations in Japan. This *Keiretsu* group is believed to offer a host of important advantages to Japanese corporations. The close relationships among banks, shareholders and partners are considered potential source of competitive advantage, particularly in channeling the activities of corporate managers in the direction of long-term growth rather than short term profitability and/or share price increase (Jensen 1989). In this scenario, stock price is unlikely to give a signal about the true performance of firms. Moreover, a prospective bid remains futile as long as stable shareholders do not move to sell their shares.

Likewise, human resource aspect of Japanese firms is also different from that of Anglo-Saxon countries. Management structure of firms in Japan is founded on some basic pillars. First, an employee’s job is secured for a life time. It is an unwritten rule and its practice is observed by the fact that when fresh graduates are recruited they are not paid in commensurate with their performance. Initially, an employee has to accept regulated compensation package which is assumed much less than the market equilibrium. As they grow up with the firm, they are promoted to higher echelon, as well as paid lavishly regardless of their performance. Moreover, external or mid-level career market in Japan is absent compared to the Anglo-Saxon countries. These factors persuade employees to grow up with the firms instead of frequently switching their career to other firms. As a consequence, lifetime employment is a sensible outcome of the system. Secondly, even if Japanese corporate law does not give employees or their representatives any formal status as a constituent of the corporations, in practice it is held that employees are the most important stakeholders. Employee-sovereign corporations are justified on the ground that the contribution and the risk exposure of the core employees are greater than those of shareholders and that employees make a major long-term investment via the seniority-based wage and retirement allowance (Araki 2005). These informal intuitions work as the basic foundations for the Japanese financial system. The system obviously renders some inherent benefits proved by its sustenance successfully for so long. At the same time, the system cannot hide some of its fundamental weaknesses. The existing body of literature focuses on different aspects of Japanese financial system in macro perspective and corporate governance and finance in micro perspective. Moreover, some aspects of systematic weakness of the system are highlighted in some studies as well. But the current paper is different from them in the sense that it examines the weaknesses through the lens of a single case which is widely discussed in the corporate and business arena due to its greater impact on the traditional form of governance. As a result, the research is timely and expected to contribute in the literature by providing new information and evidence applying micro explanation.

3. The Case of Livedoor

3.1 The Rise and the Fall

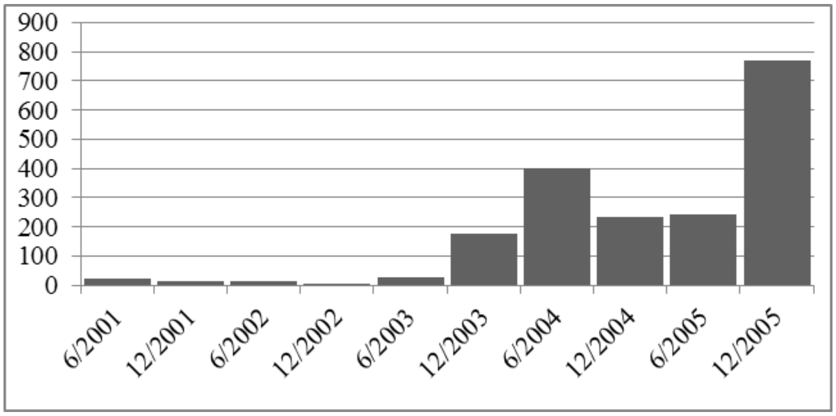
At Livedoor's establishment, Takafumi Horie, its founding CEO, dreamed of joining the echelons of Japan's wealthiest people, if not those of the world as a whole.[1] In his sophomore year at the University of Tokyo Mr. Horie engaged in a part-time job in which he encountered internet. Fascinated by this innovation in technology and its feats, then 23 years old young entrepreneur started up a website design consulting firm called Livin' On the EDGE Inc. The firm later reorganized into a joint-stock company with a capital of 10 million yen in 1997 and was renamed Livin' on the EDGE Co. Ltd. Within a very short span of time, Livin' on the EDGE Co. Ltd. registered on the TSE Mothers' market in April 2000.[2] What was astounding about Livin' on the EDGE Co. Ltd.'s progress was that the company had managed to list itself on the public market in just four years of its establishment from a start-up capital of US $50,000. Needless to say this attracted media attention to such an extent that many critics of Japanese conservative mannerisms applauded the triumph of market capitalism. This would just be the beginning, however.

In November 2002, two years after listing on the Mothers market, Livin' on the EDGE Co. Ltd acquired a free internet service business called Livedoor Corp. Following this acquisition, Livin' on the EDGE renamed Livedoor Co. Ltd (henceforth Livedoor). The company was initially fashioned into a Yahoo-style Internet portal that offered such services as financial business, corporate web solutions, data center, IP telephony, business email, news and travel information, concert tickets auctions, and online banking. Later it extended its business to include financial services and other investment funds. Within five years ending December 2005, Livedoor increased its profit twenty-two fold as well as its stock price twenty-six fold.

Mr. Horie's so-called charismatic management style also increasingly raised his profile in Japan to the point where hardly a day passed without news coverage of his business (and even political) ventures. A political stint deserves mentioning here is that Mr. Horie was courted as a candidate for the ruling Liberal Democratic Party (LDP) during Japan's national elections in 2005. He was praised by then Prime Minister Koizumi as a face of the new Japan and the symbol of 'fresh blood'. This just added to criticisms at the time of the government's liberalization program.

Mr. Horie's decision to leave Japan's most prestigious school to pursue his business interests apparently paid him well given that in less than a decade his wealth increased to over a trillion Japanese yen. At one point Livedoor's market capitalization went up to $7.1 billion, approximately 750 billion yen (Figure 2). Because of this fascinating growth, Livedoor became a model for many Japanese start-up companies. However, it created neither a new market nor any new sales or production activities to boost up its market capitalization. Since it was an investment company with an internet service provider (ISP) portfolio, more than half of Livedoor's group sales originated from financial services. Many corporate strategists argued that Livedoor Co. Ltd would have required aggressive M&As to compensate for the weakness of its principal business.[3]

Figure 2: Market Capitalization of Livedoor (in billion yen)



Source: Authors' Calculation based on Compustat Database, 2006

The argument that Livedoor's financial foundation was shaky is, however, questionable because the company operated in the service sector, a sector that comprises a significant share of a nation's GDP. This at least holds true in developed countries, which largely off-shore primary production to countries where factors of production like labor, land, etc. are cheaper. Rather, what might have been overlooked among the causes of Livedoor's downfall is that the strategy the company employed to increase its corporate value was considered unpalatable with traditional Japanese corporate practice.

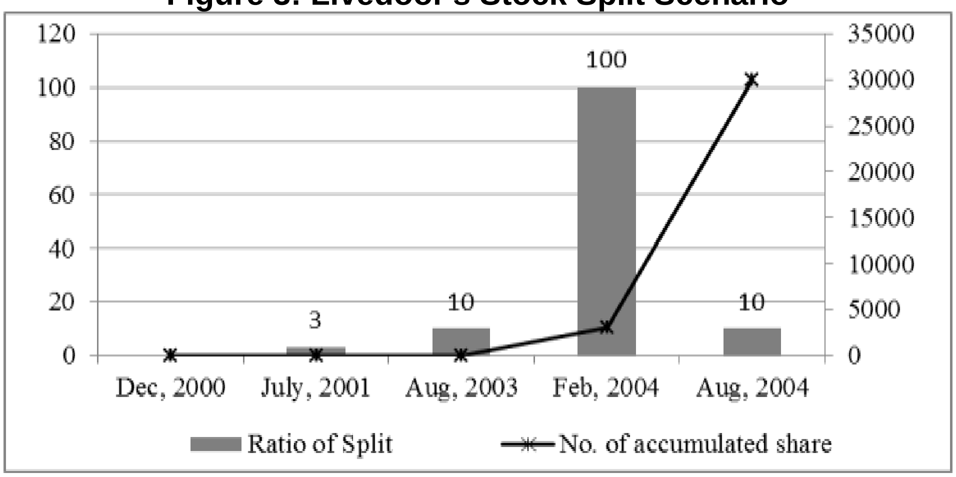
Livedoor used 'special purpose entities', stock splits, swaps, and other financing tactics common in most industrial economies to acquire a handful number of firms. However, such activities are regarded alchemical in Japan where corporate leaders still hold manufacturing as the most respectable industry in an economy. Traditional and conservative corporate leaders view internet and service firms of this nature as playing a 'money game'. Therefore, while Livedoor's aggressive takeover activities were seen by many as low-level M&As, its activities also turned the company into an eyesore to many conservative business leaders. As a consequence, though highly acclaimed (at its peak) as a model for young start-up company executives, Livedoor's CEO was at the same time under constant criticism for his unpredictable capitalist behavior. Livedoor or its CEO was not the actual cause of such concern, however. The concern rather had more to do with the discomfort traditional corporate managers had with the pace of globalization and deregulation hastened by information technology. The financing techniques on which Livedoor relied for building its edifice including stock split, swaps, and M&As are the result of financial deregulation Japan undergone after the Big Bang Crisis in the 1980s.

This on-going financial deregulation has definitely created new avenues of profit for some companies like Livedoor. There is nothing wrong with the motif of making money. However, in its quest for profit Livedoor overlooked the consequences of taking a lone path in a society where 'the group' is fundamental and trust and cooperation govern transactions. Livedoor executives were charged with manipulating the system and fabricating accounting transactions. This event was followed by price decline of company's share so sharply that share certificates became virtually valueless paper overnight. Shareholders lost all their investments in the company. The company's CEO and another three of its executives were arrested on January 23, 2006 for alleged accounting frauds and the violation of Securities and Exchange laws. The Tokyo Stock Exchange at the end delisted the firm from the bourse.

3.2 Livedoor's Takeover Mechanisms

Livedoor employed sophisticated financing techniques to boost its market capitalization. The company's management team exploited one of the anomalies inherent in the advantages of the stock-splits strategy[4] and repeatedly split Livedoor shares at an unusually frequent rate. According to its CEO, Livedoor exercised stock-split because he "wanted young people without a lot of money to be shareholders".[5] Whatever the case, Livedoor materialized the stock-splits strategy to capitalize itself. First, following its listing on TSE the company executed four stock splits. With these splits a single Livedoor share valued at 600 yen by the end of 2001 transformed into 30,000 shares by the end of 2004 (Figure 3). In 2004, when a single share was sold for 156,000 yen, the company executed a 100 for 1 stock split. This meant that an investor with a single share at that time retained his/her share worth 1,560 yen and received a claim for the other 99 shares at the same value to be honored several months later. Looking at another way, investors in a company valued at one billion yen would only have access among themselves to just 10 million yen worth of the company's actual stock certificates to trade. This creates an artificial crisis of shares which in turn creates an upward pressure in the price of the stock (Greenwood 2005).

Figure 3: Livedoor's Stock Split Scenario



Source: Authors' Calculation based on Wall Street Journal (Supra note 6)
N.B: left axis indicates the ratio of stock split; right axis shows the number of share after stock split

Livedoor not only capitalized on splitting stocks as an expansion strategy but also used these stocks to pay for firms it acquired through stock swaps. Under the stock swaps strategy, Livedoor used high- priced shares in lieu of cash to pay for newly acquired firms. Frequent stock splits helped inflate Livedoor's share prices and thereby, enabled the company to make some of its (and a large part of which were hostile) acquisitions through stock swaps. Following Mr. Horie's arrest *The Wall Street Journal* reported that "[t]he stock splits pioneered by Livedoor, plus an increase in online trading services offered by Livedoor and others, had led to such a boom in individual investing that these traders accounted for more than half of overall volume on Japan's top three stock exchanges"[6] in 2006. Upon Mr. Horie and the Livedoor management team's arrest many of the company's shareholders panicked in efforts to sell off their holdings in the company. So great was the panic that the volume of sales orders threatened to crash TSE. The bourse was forced to close 20 minutes earlier than usual, for the first time in its sixty-year history.

In one of his books, *Using Cash Flow Management to Become Number One in the World*, Mr. Horie envisaged Livedoor number one in terms of market capitalization. The ambition was great. Conservative Japanese corporate strategists, however, questioned the feasibility of such a goal given that organic growth stemming from ordinary business practice was unlikely to hasten the achievement of such an ambitious goal. Mr. Horie was well aware of this and yet went against all odds to rapidly acquire small and financially weak firms. He acquired about 50 such firms while using Livedoor's stocks as currency. From 2001 until its bankruptcy, Livedoor executed 18 corporate takeovers through stock swaps. In 2004 and 2005 alone the company effected 14 takeovers and made extraordinary gains totaling approximately 7.1 billion yen from the deals.

3.3 Livedoor-Fuji TV battle

Probably the greatest uproar in the history of corporate takeover in Japan was closely witnessed during the Livedoor - Fuji TV contest for the acquisition of Nippon Broadcasting System (NBS) in 2005. Fuji TV was a subsidiary of NBS that had 22.5 percent stake in Fuji TV and both of them are part of the Fujisankei Communications group. Before Livedoor's acquisition of NBS shares, MAC (commonly known as Murakami Fund) was the largest shareholder of NBS with 19.5 percent stake. In May 2004, MAC'S president Mr. Murakami announced that he would seek a seat on the board of NBS. The market capitalization of NBS and Fuji TV at that time valued at 180.4 and 642.2 billion yen respectively. MAC proposed to turn parent company into a subsidiary to Fuji TV as well as integrate the management of both in order to create a joint holding company. Besides resisting this proposal, the management of Fuji TV acquired shares of NBS aiming to raise its stake from 0.03 percent to 12.4 percent. MAC still remained the largest shareholder of NBS. With a view to erode MAC's dominance in NBS, Fuji TV had launched a tender offer to buy shares targeting to increase its stake to 50.12 percent in NBS.

While the Fuji TV tender offer was still valid, Livedoor launched a bid to acquire NBS. On February 7, 2005 Livedoor purchased 5.4 percent stake from the open market. In the next day, the bidder purchased another 29.6 percent of the firm's total shares through 'off-hours' deals on Tostnet (a system for trading shares outside the normal working hours). The stakes Livedoor purchased accounted for 45 percent in terms of voting rights to NBS. Livedoor entered into a contract with Lehman Brothers Holdings Inc. to finance its activities. As per the contract, Lehman Brothers issued convertible bonds worth US $700 million of Livedoor that enabled it to acquire the necessary stakes in NBS within a few minutes. This stake was particularly significant because it entitled

Livedoor to have a veto power concerning any special resolutions at a general shareholders meeting. The bid, undoubtedly, shocked Fuji TV management that believed that by acquiring NBS Livedoor would end up being one of the nation's largest media production companies as it would control majority shares in Fuji TV through NBS. For avoiding this threat, Fuji TV extended the time for tender offer lowering the target stake to be acquired from 50.12 percent to 25.06 percent. According to the Commercial Code of Japan prevailed at that time, if the subsidiary can hold minimum 25 percent stake of parent company, the latter is prohibited from exercising voting rights in the former. Thus, through acquiring 25.06 percent stake in NBS, Fuji TV wanted to put the cap on Livedoor's ability to hold the upper hand in decision making that particularly affects Fuji TV.

Meanwhile, Livedoor accumulated 40.5 percent voting right in NBS and thereby, accomplished a rare Japanese hostile takeover. In order to dilute Livedoor's stake, NBS issued sole stock warrants for 47.2 million new shares to Fuji TV for a total of 280 billion yen. If exercised, Fuji TV's stake in NBS would increase to 66 percent while reducing Livedoor's stake to 15 percent. However, there were several problems with this warrant issue. First, if Fuji TV exercises the warrant, it would exceed the maximum limit top ten shareholders can hold (75 percent) according to Security and Exchange Commission listing standard. Second, offering a bulk amount of stock warrant to a single shareholder below the market price is a clear violation of principle of equal treatment to all shareholders. On February 24, 2005 Livedoor sued against the warrant claiming that it was illegal because NBS had no clear purpose to use of the money. Tokyo District Court imposed an injunction against the warrant which was also upheld by the Tokyo High Court.

For rescuing Fuji TV from Livedoor's grasp, stable shareholders stepped forward and sold their shares responding to Fuji TV's ongoing tender offer. Shareholders including Daiwa Securities, Kodansha Ltd., Tokyo Electric Power Company, Kansai Electric Power Co., Mitsubishi Electric Corp. and many others granted a stake of 25 percent in NBS to Fuji TV. As a consequence, Fuji TV accumulated its voting right to NBS more than 33 percent when tender offer ended. Furthermore, NBS decided to sell core assets such as 56 percent shareholding in Pony Canyon Inc. to Fuji TV. Selling most valuable assets to friendly firms is called '*crown jewel*' which is a defense technique against prospective takeover. Surely, this decision stirred up Livedoor that sent a letter to the directors of NBS requesting them to retain key assets of the company otherwise it would be forced to recourse to court for shareholder suit.

On March 26, 2005 Livedoor announced that its stake in NBS reached equivalent to 50 percent in terms of voting rights. In this circumstance, it was believed by the Fuji TV management that Livedoor would target Fuji TV next. Fuji TV thus, resorted to various anti takeover measures. For instance, Softbank Corp., a Livedoor rival, agreed to rescue Fuji TV. As per the agreement, NBS offered to lend its 13.88 percent of Fuji TV voting rights to Softbank for five years stock loan agreement. This would increase Softbank's total voting rights in Fuji TV to 14.67 percent. NBS temporarily succeeded in transferring a bulk of its Fuji TV shares to a safe heaven through this arrangement. It then loaned the rest of its Fuji TV shares – about 9.12 percent voting rights – to Daiwa

Securities SMBC Co. to avert Livedoor's hostile takeover attempt. The two months long battle between Livedoor and Fuji TV over NBS takeover finally ended with an arrangement, where Fuji TV purchased the whole of Livedoor's 50 percent stake (in terms of voting rights) in NBS along with 12.75 percent of Livedoor's original shares for 44 billion yen. This made Fuji TV the second largest shareholder in Livedoor after Mr. Takafumi Horie (the founder president of Livedoor). In September 2006, NBS became a wholly-owned subsidiary of Fuji TV.

Livedoor - Fuji TV battle over NBS has profound implications for Japanese corporate governance in general and takeover markets in particular. Livedoor was victorious in the stock warrant case as the courts ruled in its favor. The victory was undoubtedly temporary. Livedoor did not do much to correct the negative sentiments it has created in the minds of typical corporate leaders by inviting them into an unfriendly game like hostile takeover that are still considered alchemic in Japan. As a result, Livedoor was likely to receive its due retribution. Prosecutors and Security and Exchange Commission (SEC) officials publicly raided the company's head office on the pretext that it misled investors by disclosing wrong information in order to inflate share price of one of its subsidiaries, Livedoor Marketing Co. The investigation was followed by the arrest of Livedoor's CEO on charges of account fabrication and finally the firm was delisted from the bourse. Corporate analysts and scholars consider it an irony that the target firm survives whereas the acquirer turns into a history of time.

4. The Systemic Weakness

Livedoor case has profound implications for Japanese relation-based financial system in general and business management in particular. It is true that Livedoor was victorious in the stock warrant case because courts ruled in its favor. The victory was undoubtedly temporary because it did not do much to correct the negative sentiments the company's CEO's behavior had attracted among Japan's conservative corporate leaders. He not only publicly criticized and challenged the traditional financing and business practices but also he was on record as saying, "[a]ll evils come from aged business managers."[7] It apparently struck a blow to Japanese business etiquette and tradition and thereby posed a threat to old-fashioned corporate leaders. This can be justified from the perspective that the techniques to which Livedoor resorted for building its empire are at odds with the long-lasting practice of corporate culture in Japan but are not at odds in the legal sense. For instance, the allegation that Livedoor fabricated accounts raises doubts and indeed questions about the role of auditors as potential watchdogs of corporate wrongdoings. Equally brought into question is the notion of the independence of auditors. Livedoor's audit firm, Koyo & Co., was probably unable to discharge its rightful duty as an attestation service provider since its interests in Livedoor conflicted with the obligation to warn its clients in the face of danger. With a work force of 12 accountants and a client base of seven listed companies, Koyo & Co. heavily relied on Livedoor for business.

The concerted collaboration between Livedoor and Koyo & Co. in fabricating or hiding accounts is not a practice new to Japan as far as audit work is concerned. Establishments like the Japanese household goods company, Kanebo, turned itself from a loss making to a profitable company by merely manipulating accounts for the five years leading to 2003. TSE delisted the firm from the bourse on June 13, 2005 for systematically falsifying financial statements in order to inflate sales and earnings. Kanebo's case is held to be one of the biggest accounting frauds by a non-financial company in Japan. Kanebo's case came to light at a time when the company was planned to restructure under the auspices of the Industrial Revitalization Corporation of Japan (IRCJ). In the process of valuing the Kanebo's assets, however, IRCJ discovered inconsistencies in firm's accounting data. Public criticism of Kanebo's lack of transparency also compelled then president, Akiyoshi Nakajima, to commission a team to investigate illegalities in the company's past accounting practices and business transactions. The investigation revealed that the firm had a recurring negative net worth for each of the five years leading to fiscal year 2003. The duration for which Kanebo recorded negative net worth goes against TSE listing rules and qualifies for delisting. Nonetheless the company's audit firm, Chuo Aoyama Pricewaterhouse Coopers, stayed mute on the matter. The announcement of Kanebo's delisting from TSE brought down the company's shares from 1,670 yen per share to 360 yen.[8]

The paucity of accounting professionals like auditors (and audit firms too) contributes to conflicts of interest in the practice of corporate governance in Japan. Audit firms compete for client-firms in countries where the former are numerous. Reputation is an important criterion for the selection of audit firms in such circumstances. Relative scarcity of such service firms and related professionals in Japan may also be an indicative of less demand for such service. This can be attributed to the fact that like other spheres of the economy, governance in corporations was also dictated by so-called administrative guidance. Administrative guidance is a sort of authority of government by which it issues requests, suggestions, and encouragements to the enterprises to behave in certain specific ways (Johnson 1982; Kester 1991). Following the bubble burst in the 1990s, the MOF heavily intervened in certain accounting rules which were contrary to fair accounting practice. For instance, MOF allowed banks to recognize marketable securities at cost instead of lower of cost or market value, so the banks did not have to recognize the losses in their financial statements. Moreover, the MOF also allowed banks to write real property up when the market value was above the cost, so as to recognize an accounting gain (JICPA 2008). These treatments were contrary to global accounting standards, which emphasize recognizing marketable securities at their market values.

Such favorable guidelines to corporations not only undermine real quest for attestation services like auditing but also help establishing cozy relationships between audit and client firms. This sort of relationships between shareholders and managers manifested in the Livedoor and Kanebo might have failed to foster the development of strict accounting procedures and practices in Japan. Japanese society on the other hand also appears to have accepted such practices as standard given the norms on which the practices are founded. The widely discussed Daiwa Bank's scandal is a case in point. Daiwa Bank's New York branch had amassed a cumulative loss of US $1.1 billion from 30,000 unauthorized trades for 12 years when the incident came into light in 1995.[9] The branch used to sell customer's as well as its own securities in order to offset losses from trades. In an occasion, Toshihide Iguchi, person in change of security trading at NY branch, wrote a confession letter to the Daiwa Bank's president in Japan. Upon receiving the letter the president decided to maintain the secrecy and cooperate with NY branch. The president along with other top Daiwa's executives met informally with MOF officials in which the officials approved Daiwa's position (Aronson 2003:21). Overlooking unauthorized trades of securities to cover up losses for such a long period of time implies that neither the audit firm nor the directors were aware to disclose facts for which they were entrusted. This action was further accepted by the highest administrative authority perhaps because of business judgment rule.

This sort of oversight is often excused as long as the actors maintain informal administrative guidance that has no clear definition. As such, the system as a whole is rarely exploited due perhaps to the fear that favorable administrative guidance will be withdrawn from would-be deviants even if the deviation from the said practices may not be legally wrong *per se*. In view of this, Livedoor was in all probability an affront to social practice and networks. Another important movement by which Livedoor antagonized the standard practice was its listing. The firm listed on the TSE Mothers market. The conventional wisdom in Japan for start up companies is to establish them first and then strengthen ties with banks that subsequently act as their main banks should a start-up succeeds. This helps not only to nurture baby-firms but also to prepare them for future growth. The bond between a bank and a start up company facilitates effective bank monitoring of firms' performance as well as activities and orientation to society's rules. Livedoor`s outright listing on TSE Mother's market without following conventional rules translated into a challenge to the widely held practiced of the society.

Livedoor acquired major share of NBS on off-hours trading using Tostnet. The system was legal but Livedoor squeezed its unintended consequence. This exploitation of system raises doubt about the monitoring infrastructure and professional capacity of the stock exchange. Furthermore, the fact that Livedoor's acquisition of NBS went unnoticed in spite of the requirement for listed companies to give immediate notice to the stock exchange on matters of vital investment decisions raises questions about TSE's supervising capability. Granted, Livedoor exploited Tostnet based on the knowledge that a series of transactions on Tostnet would enable it to acquire a large part of a company's shares before the company's management or key shareholders realize it. For Livedoor, Tostnet was an easy means of manipulating the corporate market to meet its own ends. As seen earlier, Livedoor had at some point acquired shares worth 29.6 percent in NBS. The company purchased these shares from the six big sellers on Tostnet before the start of regular trading hours without disclosing the amount of shares traded. In an interview with the *Daily Yomiuri Shimbun*, Bill Emmott, editor of *The Economist* said of Livedoor's conduct, "[t]his would not be allowed in the London market. This would be illegal in the London financial market. But it was allowed [in Japan] and had always been allowed…but no one really exploited this because they didn't think they would be able to succeed with a corporate takeover for other reasons".[10] Livedoor dared to deviate from this tradition and probably received the punishment in due course.

It was mentioned earlier that Livedoor capitalized on financing techniques for its growth and expansion. It acquired firms one after another through takeover bids majority of which were paid by Livedoor's stock instead of cash. Undoubtedly, Livedoor tried to increase the price of its share by frequently splitting them up. But stock splitting was neither prohibited nor completely absent in Japan. Pulling off a big ratio as Livedoor did, however, was unusual and unprecedented in Japanese stock-split history. Only 34 firms split stocks in Japan between 1995 and 1998, whereas the number rose to 400 firms between 2003 and 2004. Over 95 percent of the stock splits executed in the country before 1995 were in ratios (average) 1.3 shares for 1 or less whereas the latter period saw higher ratios in stock splits. For example, New Deal Inc., an online music distributor, executed 1000 shares for 1 split in February 2004 (Milhaupt 2005). The proliferation of stock splits in Japan in recent times can be attributed to two crucial regulatory changes. First, TSE in October 1999 changed the rules governing stock brokerage commission and set a fixed rate for small transactions. Following deregulation, cut-throat competition among brokers has further lowered the rate. This ultimately encouraged managers to go for frequent and high ratio stock splits. Second, the law requiring net assets per share to remain above 50,000 yen was repealed in 2001. This change has made it easier for the public to buy shares. It has also enabled and even encouraged firms to split shares at much lower prices. Livedoor took advantage of the system's unintended purpose but did not violate it. Responding to this move, TSE finally has enacted rules forbidding companies from splitting stocks in ratio higher than 5:1. It has also amended regulations on off-hours trading finally.

5. Conclusion

This paper has attempted to describe the relation-based financial system of Japan and possible threat associated with the system. Japanese financial system can be characterized bank-based or relation-based system because major share of corporate finance is channeled through the banking intermediation. As such, a tightly-knit relationship has been formed between financial institutions and firms monitored at the top by regulatory authority particularly the MOF. The system depends more on informal institutions than formal laws and regulations which have been evolved through practice over time. Informal institutions are dominated by culture, traditions, and social practices. These social practices have been transformed into business practices which are tacit rather than explicit. The embedded advantages of the system are that formulation and enforcement costs of laws and regulations can be minimized. Furthermore, the intermediation process the system is featured with is termed to serve the needs of developing and reforming economies better than anonymous capital markets modeled after the Anglo-American financial system. Banks information collection through direct intervention in Japan seems to be quite effective on the ground that a clear and committed relationship between banks and their client firms help minimize transaction costs. Moreover, as the largest stakeholder, the main bank has definite interest in assuring sound management of the company thorough their mutual interactions that eases main banks to collect information of the firms on a regular basis which, therefore, enables them to carryout effective monitoring.

Possible risk of tacit rules can stem from the danger of exploiting the system by any maverick market maker. Our analysis of Livedoor's activities points out the areas of possible threats. Firstly, the attestation services or audit work needs to be carefully monitored. Paucity of audit firm has paved the way for creating a conflict of interest between audit firms and their clients. Our analysis shows that society accepted such practices as long as both entities were under the administrative guidance. Livedoor did not comply with this tradition and therefore, received the consequence. Second, an active market for corporate control is absent in Japan. Because market participants try to shun away from the so-called 'hostility' ensued from hostile takeovers. Livedoor acquired a handful number of firms most of which were hostile. This capitalist practice created an unprecedented level of antagonism in the minds of both regulators and other participants. This was however, not illegal but anti-social. In the case of Livedoor's bid for NBS, the target firm used 'poison pill' defense which according to the court's view was not legal. But ultimate failure for acquiring firm to take over the target at the end proves that informal institution triumphs over the formal one. More so, the target firm survives whereas the acquirer has turned into a history of time. Third, Livedoor used stock split, no doubt at a high ratio. But it was not the only firm that exercised stock split to such an extent. Stock split was not a problem for other firms but it was for Livedoor because it used its stock as currency to acquire new firms.

Looking at all the above mentioned facts, it can be concluded that the system can be exploited if someone dares to do so. These are the weaknesses embedded to the relationship-capitalism. It is observe that following the Livedoor incident many firms sought shareholders' approval for new anti-takeover measures.[11] Some policymakers can argue that corporate restructuring through the creation of new rules in the name of protection from sudden takeovers might be taking matters too far in the sense that conservative business leaders may attempt to tarnish the reputation of freewheeling capitalism by citing the example of Livedoor. Moreover, it can also be an attempt to show the prospective takeover contenders that the society is not yet ready for such an action. However, how well this practice fits for a country like Japan at the dawn of 21st century when globalization is penetrating in every nook and corner of the world requires further research. Relative advantages and disadvantages of the system compared to the Anglo-Saxon system is the research issue which we like to aspire in the future.

Endnotes

[1] Nikkei business cited an excerpt from Takafumi Horie, CEO of Livedoor, "My target is to become number one in the world market. I do not care to become number one in Japan. I always watch Google and E-bay and think to compete in the global market." (*Nikkei Business*, Dec. 12,2005)

[2] The Mothers market is TSE's emerging stock market established by the latter in November 1999 as a means of encouraging young, upcoming and innovative companies to list on the stock exchange. The listing requirements for the first and second sections of TSE include positive past performance as the market is originally set up for well-established companies. The Mothers' market on the other hand provides opportunity to companies with high potential by emphasizing disclosure rather than past performance.

[3] "A way of looking at profit" *The Japan Times*, February 3, 2006

[4] The stock splits strategy is designed to create shares that are affordable to many small investors, most of who may be individual and retail shareholders. The strategy works thus: theoretically, a 10 for 1 stock split for example – in which a company issues 10 shares for each share held by an investor – should bring the issuing company's share price down to one tenth of the current level. Going by the law of supply and demand, however, share prices often rise when there is a temporary shortage of stock certificates. This is because several months are required to print out and deliver the new stock certificates. The implication then is that in the case of a 10 for 1 split, a holder of one share can only receive 90 percent of

his/her share after several months. In the meantime he/she can not sell the shares at hand. The limitation imposed on investors' ability to trade their stock until the elapse of the stipulated time leads to the rise in price.

[5] "Living on the Edge" *TIME*, January 30, 2006, pp. 22-25.

[6] "In Japan, a Brash Deal Maker Takes a big Tumble" *The Wall Street Journal*, February 3, 2006

[7] "Living on the Edge" *TIME*, January 30, 2006

[8] "Four CPAs arrested over Kanebo scandal", *The Japan Times*, September 14, 2005 (retrievable at http://search.japantimes.co.jp/cgi-bin/nn20050914a1.html last accessed on February 12, 2006)

[9] "I Didn't Set Out To Rob A Bank", *Time,* February 10, 1998

[10] "Economist editor looks at Livedoor" *The Daily Yomiuri*, February 2, 2006.

[11] "Collateral Damage" *TIME*, January 23, 2006 (retrievable at http://www.time.com/time/magazine/article/0,9171,1151854,00.html, last accessed on February 15, 2006)

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