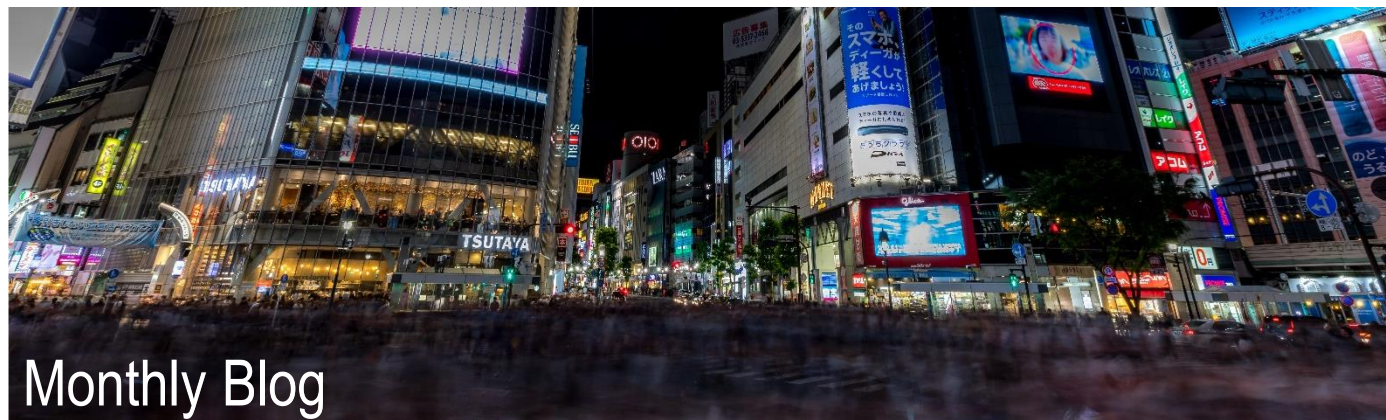

PM's Perspectives

May 2021

What do stock companies mean for shareholders?

Given the fact that management and shareholders now have more chances to talk each, they should share their views and visions on issues such as what is the role of stock companies and how the former and the latter are related to each other in order to make the dialogues more fruitful. Today I would like to discuss how Japan's Corporate Law sees stock companies and what shareholders should pay attention to, with the book "Corporate Law"[1] written by Wataru TANAKA as a reference.

To begin with, the following is a definition of terms related to stock companies under the Corporate Law.

- A company is a profit-oriented and incorporated association.
- Profit-oriented means making profits through business activities and distributing them to members.
- No one but shareholders are entitled to membership of the Company.
- In Japan, "members" often refers to employees. But employees are not legally members. Employees are not constituent members of the company but only one of the parties to a contract with the company.

As you can see above, stock companies are supposed to generate profits and distribute them to shareholders. On the other hand, shareholders have to tolerate disadvantages such as uncertainty on the amount of dividends and a subordinated position to creditors. Shareholders cannot know the amount of dividends in advance, and the source of shareholder returns is limited to the surplus and residual assets. For this reason, not only growth strategies but also capital policies on investment efficiency and shareholder returns among others have great significance for dialogues between the management and shareholders.

Another feature of stock companies is the separation of ownership and management. A person who has funds but lacks management skills can become a shareholder and select experts in management as directors to run the company. This is why a stock company is said to be basically a mechanism where shareholders select directors and delegate its operation and management to them. Directors receive a compensation from the company in return for their management skills.

The problem here is that the management can abuse their power and infringe the interests of the company and shareholders. Managers may receive a compensation worth more than JPY 100 billion or could deteriorate the company's financial standing by introducing an M&A project.

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The reason why the corporate law grants shareholders a common benefit right which enables them to participate in, oversee and rectify the management is to let them coordinate their interests with the interests of directors. We can cite voting rights at general shareholder meetings as an example of this right. Market participants see cross-shareholdings and listed subsidiaries as a problem because these corporate practices dilute the common benefit rights of shareholders. The common benefit right is an important governance issue for shareholders when they talk with the management. That said, shareholders' rights might be restricted in the future if they repeat activities that are undesirable for society, given the right to select and remove directors was granted to them on the assumption that this system is suitable to improve management efficiency and will contribute to society in turn.

Shareholders' rights

Right to self-interest	This is a right to receive economic benefits from the stock company. E.g. Rights to receive distribution on dividends and residual assets.
Common benefit right	This is a right to participate in, oversee and rectify the management. E.g. Voting rights at shareholder meetings/rights to oversee and rectify the management/rights to file a suit/rights to read board minutes.

Source: SMDAM (Tokyo), 10 May 2021. Created by the author based on reference material. Shareholders can improve the precision of investment by reading and analysing board minutes.

As the table above shows, shareholders have two rights but a company does not belong to shareholders. They only have a right to receive profit which is a surplus after the company deducted material/parts costs, personnel costs, interest expenses, tax burdens and so on from its sales. According to the law, shareholders should not interfere in the detailed management of individual products under this system where they grant management rights to experts. If shareholders want to help managers, all they can do is to provide excellent examples of other companies based on a broad range of interviews and ideas on financial, IR and ESG policies based on financial expertise.

In summary, the mission of stock companies is to generate profits and distribute them to shareholders, while shareholders should pay attention to topics such as how the company will increase shareholder returns, what kind of capital policies the company should adopt to maximise investment efficiency and shareholder returns and whether the company will improve governance issues or not in dialogues with the management. In other words, our purpose to talk with the management is to know how they are planning to increase EPS and ROE (not the operating income) and through which shareholder return policies the company can maximise its corporate value (not how to provide stable dividends) and so on.

Reference Material

"Corporate Law" written by Wataru Tanaka (University of Tokyo Press)

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