

## ASIAN LEGAL REFORM AND COMPANY INFORMATION DISCLOSURE

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### SUMMARY

Asian legal reform is proceeding in three directions:

- (i) Reform in line with advice from IMF and the World Bank.
- (ii) Reform with a view to strengthening international competitiveness through stronger protection of intellectual property rights.
- (iii) Reform to get membership of WTO and reform of state-owned enterprises.

When reforms are made in business-related laws, the text of new laws reflects situations in each country. Considering the content of reforms to business laws, based on the idea that corporate governance aims to increase the profits of those with interests in companies while maximizing the shareholders' value, there are some cases that the reforms are not necessarily directed toward building of strong and fair companies.

Reforms related to company law center on company information disclosure on stock exchanges in (i) above, and on amalgamation of troubled state-owned enterprises to ensure their survival in (iii). The latter leads to continuation of management by state sector in many cases. Company information disclosure based on trustworthy accounting information assists in the establishment of strong and fair companies.

In the field of reforms of law of intellectual property rights, Malaysia stands out for its enthusiastic approach. The protection of technology knowhow and

business secrets leads to technology innovation as well as managerial innovation.

Reform of collateral law is bringing moves towards the registration of effective chattel mortgage, thus changing current mortgage business, which is overdependent on real property. One such example is the Fiduciary Transfer Act, which was enacted in Indonesia in 1999.

The most prominent aspects of reform of insolvency act are legislation to make liquidation-type insolvency procedures effective, and revisions to protect the rights of both new money providers and previous managers in rehabilitation-type insolvency procedures. Progress is also being made in insolvency transactions through private arrangements.

In the field of reform of competition law and industry laws, legislation is proceeding in directions (i) and (iii) towards fair market transactions. The competition law has a possibility of serving as a distorting means of introducing new industrial policies.

It is effective for Japanese and Japanese-affiliated companies to consider the impact on their practical business by contents of legal reforms in Asian countries, and establish corporate governance that leverages their corporate information disclosure and their emphasis on technology. The establishment of corporate governance, which is the purport of legal reform, helps to build strong and fair companies, even if the reforms are not directly applicable to Japanese-affiliated companies.

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## INTRODUCTION

The results of a questionnaire survey on direct foreign investment by Japanese manufacturers, which were published in the inaugural edition of JBIC Review (January 2000), showed that Thailand, Indonesia and Malaysia ranked third, fifth and seventh in the list of potential investment targets for the medium term. Many Japanese companies are knowledgeable on the business laws system in those countries, but the new legislation and revisions which have taken place since the Asian Currency Crisis have brought considerable changes to the legal landscape. The results of the questionnaire survey also indicated that local legal systems were a prominent concern in China and Vietnam, which ranked first and sixth respectively as investment targets.

This paper will present an overview of local business laws in these countries and analyze the situation with a view to the necessity of company information disclosure for the establishment of corporate governance. The narrative will proceed from legal relations with the persons interested within companies to legal relations with external interested parties. Chapter I will examine the three directions of legal reform. Chapters II and III give examples of the importance of keeping abreast of changes in the legal environment when doing business in foreign countries, and introduce the author's observations on corporate governance based on personal perceptions of problems. Based on this material, Chapter IV and subsequent chapters give an overview of company law and accounting, which are the foci of corporate sector reform, in the cases of Indonesia, Thailand, Malaysia, Singapore, Vietnam and China. Chapter VIII covers reforms related to intellectual property rights, which could be valuable tools for enhancing company values. Chapters IX and X examine reforms of collateral law, which are central to business finance, and reforms in insolvency law, which is used to settle transactions between interested parties when a company becomes insolvent. Finally, Chapter XI is an overview of competition law and industry law, which are most peripheral to a company in its relations to the market society.

## CHAPTER I THE DIRECTION OF LEGAL REFORM

### 1. THREE DIRECTIONS OF LEGAL REFORM

Thailand, Indonesia and South Korea, which were hit by the 1997 currency crisis, have been making progress on legal reform, in two main directions:

- (i) Reconstruction of fragile financial institutions and market structures.
- (ii) Reform of the corporate sector, which lacks adequate corporate governance.

The legal reforms were spurred by the special finance extended by IMF and World Bank to counter the lack of foreign currency caused by the currency crisis. The conditions attached to the finance included legal reform. Even Malaysia, which suffered from the crisis but did not receive IMF or World Bank finance, is making progress in legal reforms aimed at improving the legal system, with particular emphasis on expanding intellectual property rights. Malaysia is doing that to make itself more competitive internationally. The third direction of reform is emerging in China and Vietnam, which did not suffer directly from the currency crisis but are making progress in legal system reform, with the aims of reforming state-owned enterprises and joining WTO.

Many of the new laws concern business with Japan or direct investment from Japan. Other legislation can be put into categories concerning company law, intellectual property law, collateral law, insolvency law, competition law and commercial transaction law. In the laws of Southeast Asia and East Asia, it is important to consider the problems of practical application. In some cases it is not clear how far the regulatory content of a law will actually be applied in practice. Therefore reform is directed not only at the substantive law, but also the adjective law which is the law of procedures.

Even in the case that debt collection fails because of not preservative attachment procedure being made based on local law, the fact that a company does not know the local law can be accepted within a principal of management decision by Japanese Law in Japan,

and there is also a possibility that derivative action cannot be defeated against board of directors in Japan.

However, this is understood in local areas as “Japanese companies are easy to win over”.

## 2. TWO FLOWS OF INTELLECTUAL SUPPORT FOR LEGAL SYSTEM IMPROVEMENT

In Asia it is necessary to understand local laws that are based on the problems of putting legislation into practice. After the currency crisis IMF and the World Bank encouraged governments to pass local laws and strengthen their application, and US companies, looking on that as a good opportunity, are trying to expand the scope of their business activities. US lawyers are becoming contract lawyers for the World Bank, and USAID, which is the US government’s aid agency, and they are assisting in the creation of local laws. In 1997, when the author was stationed in Kazakhstan as a JICA expert, the key legal adviser to the Kazakhstani presidential office was a lawyer from Louisiana who had completed service in the Russian presidential office assisting in legislation. Russia, which follows the Civil Code System, employed a lawyer with experience of practice in Louisiana, which has been strongly influenced by the French legal system. Another young American lawyer who was assisting the Ministry of Justice and was main for cooperating the legislation of the Company Act has been working for the Philippines’ Securities Exchange Committee (SEC) since 1999 on the reform of the Corporate Bankruptcy Act. Another American lawyer, a colleague of his, has been assisting the legislation of the Chattel Mortgage Act in Rumania. The legislative advice will tend to be slanted towards U.S. Law. The American style of law appears to be becoming the standard for Asia’s legal system reforms.

Japan’s support for legal systems follows a friendly, low-key approach, saying “look at the good and bad aspects of the Japanese legal system and use what you can”. This approach is starting to take effect to some extent in China and Vietnam. The only countries of considering introducing Japanese legal systems are Vietnam, China, South Korea and Tai-

wan, the “chopstick cultural zone”. Laos and Cambodia are also for asking Japanese support in legislative work, but they are not necessarily moving in the same direction as the development of Japanese companies. The addition of legal assistance under the Miyazawa Plan to Japan’s plans for aid to Asian countries, which already included public finance and technical assistance, is also very significant for Japan’s cooperation with the World Bank and IMF. Japan’s legal system assistance has concentrated on educating and training the law officers and judges who manage and apply the laws. This approach has been welcomed because it does not infringe on a country’s sovereignty over its enactment work.

## CHAPTER II LEGAL REFORM AND THE BUSINESS ACTIVITIES OF FOREIGN COMPANIES

American companies are seizing on legal reform as a great opportunity to aggressively develop their business activities, while the policies of Japanese companies are against joining such moves. This difference could easily degrade the competitiveness of Japanese companies. On the other hand, illegal actions by foreigners are unlikely to be forgiven on the grounds that they were ignorant of the local law. The possibility of breaking the foundations of Japanese business in Asia, which companies have been diligently building over the last 30 years, must at least be taken into consideration. Since the start of 2000 there have been many reports of the reconstruction of the Asian economy. Many Japanese companies appear to be considering recommencing their business operations in their old form, but it is necessary for them to bear in mind the risks brought about by changes in the legal environment, as seen in the examples below.

WTO agreements and other international treaties are not all which give a large impact on legal reform (WTO agreements will be discussed further in Chapter VIII). The OECD Treaty to prevent Bribery from Foreign Public Officers is consolidated with local nationalism and will have a strong impact on foreign and foreign-affiliated companies. Also, foreign civil

officer bribery charge is a crime under Japanese law, but not under local law. Japan's Fair Competition Law was revised and added to in response to the above OECD Treaty. Under criminal law only natural persons are punished, but under the Fair Competition Law, both natural persons and corporate bodies are punished. Natural persons are subject to up to three years of penal servitude and fines of up to ¥3 million, while corporations are subject to fines of up to ¥300 million. Therefore bribery of public officers is punishable under Japanese law even in countries such as Indonesia which are not OECD members. For example, if bribery in Indonesia was carried out in Hong Kong or Singapore, the preparations for that bribery would have taken place in Japan, and would therefore parties in Japan would be deemed to be domestic crime or conspiracy joint principal.

Since the Wahid Administration took office in Indonesia in October 1999, now it should pursue unlawful moneygrubbing by former President Soeharto has been an issue. It was reported that, in the process, a number of Soeharto family businesses connected with Japanese companies are beginning to be doomed. However, many are subjected to unfair criticism. One typical criticism is that the electricity selling price under IPP businesses were excessively high, inflicting losses on the country. It is unavoidable that electricity charges increase under projects where none of its own funds are used and leaving foreign private-sector companies to construct, own and operate power stations, for which the country only buys the electricity for 30 years, when considering burden of risks and funding costs. According to the local public opinion, foreign companies are wealthy and value social confidence, thus they refer to social responsibility of foreign countries more than local companies. In such situations, the law becomes reliable for companies.

## CHAPTER III CORPORATE GOVERNANCE

### 1. MODELS AND OBJECTIVES OF CORPORATE GOVERNANCE

There seems to be a problem with the idea that emphasizes the social responsibility of a company more highly than the maximizing principle of shareholders' value of \*1. A precondition for existence of companies is apparently that they bear the social responsibility not to harm the public interest. This author is of the opinion that a company's responsibility for advancing the public good must not oppose the maximizing principle share of shareholder's value\*2. The aim of corporate governance is to increase the benefit to the parties with interests in a company while maximizing profits to shareholders in that company. The interested parties are the shareholders, managers, employees, trading partners, consumers, local community, nation and those planning to invest or do business in the company.

According to this concept, the company should be able to gain trust in the marketplace through the measures listed below. Greater trust reduces transaction costs, making the company more efficient and profitable.

- Increased transparency.
- Publication of proper and transparent financial statements.
- Increased check functions applied to management.
- Publicizing its possession of technology, skills and expertise which make it more attractive to the market.

Without disclosure of information, the management and the major shareholders fall into a cozy relationship and the intensifying competition to provide

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\*1 According to US court ruling, it allowed a resolution of directors meeting that went against shareholders' interests by refusing a hostile takeover of a newspaper and buying back its own shares. The ruling was based on the idea that benefit of the public people caused by regional dominance were bigger than the benefit of shareholders. This Herald Case in 1972 became a leading case which scrapped the idea that "a company was operated for its shareholders". (Mikiko Nakamura, "The Social Responsibility of Companies", Chuo Keizaisha, 1999, p.44-45).

\*2 The author is of the opinion that corporate philanthropy in the form of mecenat (cultural aid) and charity is appropriate insofar as it serves as advertising that works to the company's benefit.

finance leads the client's main bank to become lax in its checking functions. It is very significant to note that some companies operating in such conditions still pursue good corporate governance, perform well as businesses and are well regarded by the market. The author expects Japanese companies which operate overseas to perform such a role. Foreign-affiliated companies stand out in local society and are perceived as being rich enough to pay fines, thus it is basically difficult for them to behave improperly. Asian countries levy lower corporation taxes than Japan does, and it is easier to pay larger dividends. The parent company can export components with the overseas company as a client, thus raising profits, but it is more in line with the principles of corporate governance to improve the business performance of the local company and increase its dividend. Until now the debate in Japan over corporate governance has only been going on in large-scale listed companies, but corporate governance should also be applied to non-listed small and medium affiliated companies and small and medium businesses.

## 2. INTERESTED PARTY MODELS AND LEGAL REFORMS

Legal reforms are examined from the point of view of corporate governance that seeks to maximize the shareholder's value while increasing benefits to interested parties. Reforms concerning company law concern ways that interested parties inside and outside the company can check its management and increase its shareholders' value. In many cases the management are nominated by the dominant shareholder, which risks cronyism. Empowerment of small shareholders, stronger checks by auditors, audits by certified accountants, greater levels of disclosure of financial information and the appointment of directors from outside the company serve to prevent cronyism. Systems can also be introduced to encourage management and employees to maximize profits, such as stock option and employee stock ownership plans. Organizational restructuring schemes can serve as a way out of deteriorating management to a better standard of management. Company amalgamation

and partition of company legal system are systems for maintaining shareholders' investment through the use of general succession.

Reforms related to insolvency act serve to clarify the relations of rights between the interested parties when a company becomes insolvent, recover debts for secured creditors, unsecured creditors, employees and shareholders, in that order, and determine the scope of responsibility borne by the management. In many cases, it is shown that it is possible to conduct rehabilitation-type insolvency transaction by reserving the current execution of right on the part of the interested parties, and reforms are made to provide a legal basis for that process. Reform of collateral law is based on the awareness that the overdependence of Asian collateral systems on realty and shares has created weak financial and corporate sectors. Commercial customs by which a subsequent mortgage cannot be set without the consent of the first mortgagee, the guarantee of debts by company managers who do not anticipate ever having to cover the performance guarantee, and the malfunction of courts in collateral execution, all diminish the banks' function of acting as interested parties in making checks on management. In addition to simple realty collateral executing procedures, the legal reform is currently proceeding to supply to a wider range of interested parties, such as correspondent creditors and banks which are not major clients, by enabling the registration of new forms of collateral, such as accounts receivable and leasehold.

Competition law aims to secure the interests of consumers by encouraging market competition. On the other hand, consumer protection act starts from the assumption that consumers start from a weaker position than companies in contracts, and aims to guarantee that they are on an equal footing. Labor protection act considers the fact that workers are in a weaker position than their employers in their employment contracts and aims to make reforms that puts them on an effectively equal footing in employment contracts in treatment and wages and also in pensions and health insurance. Reforms to industrial law include reform of the bank laws, and reform of Alien Business Act. These laws govern the degree to which discrimination between domestic and foreign

investors is permitted. The protection of intellectual property rights guarantees the fruits of technological developments for their inventors, including companies, and create a market economy for technology, so that the impact on the interests of trading partners are faithfully reflected. The content of intellectual property rights includes many things which should not, in themselves, be published without compensation, but the possession of which should be disclosed in order to increase shareholders' value.

All these reforms guarantee the predictability of the law and secure freedom in business activity, including the distribution of losses among interested parties should that business activity end in failure. It is anticipated that a proper corporate governance will be attained by disclosing company information in all fields. Therefore even if company information disclosure is not made mandatory by law, it becomes increasingly true that it is better to disclose the information as part of company strategy. Strengthened investor relations, that discloses information in a timely manner and discloses company information to institutional and other investors, the publication of matters such as management concepts, and the publication of accounts beyond financial statements, such as environmental accounting and human resources assets accounting, are used increasingly often as a way of enhancing market evaluations of the company and increasing shareholder's value. If companies move as quickly as possible to disclose disadvantageous information as well, it is often possible to minimize the reduced market evaluation to a transient problem.

## **CHAPTER IV REFORMS OF COMPANY LAW IN COUNTRIES HIT BY THE CURRENCY CRISIS**

### **1. COMPANY LAWS FOR THE SAKE OF SECURITIES INVESTMENT**

In the first half of the '90s, both Thailand and Indonesia revised their company laws and securities exchange act to encourage securities investment by

foreign capital. However, the content of those revisions was not adequate, and there was no major change in the previous situation of family control of companies. Furthermore, there was no clear policy on the importance of auditing, and the revisions did not always lead to corporate governance oriented to management based on transparency. For foreign investors who are probably only concerned with local company laws and securities exchange act for the purpose of investing in the stock exchange market are unlikely to worry that the content of the laws is only superficial, provided the share market remains strong. Japanese-affiliated companies were interested in local company laws in connection with direct investment, but it appears that they were only interested as far as it concerned grasping managerial authority. That was the case because they believed that it would be enough to simply transfer Japanese-style management. Since they built up heavy debts and were hit by the bursting of the bubble economy and the Asian Currency Crisis, they have come to believe that in order to build a strong and fair company they must have stronger corporate governance, including transparency, emphasis on auditing, and check functions applied to management.

Over a period of two years the World Bank was calling for Indonesia to establish a governance committee comprising members both from the bureaucracy and private sector. Indonesia has handled the issue in the past with registration of the financial statements of major companies in business registry offices, but in August 1999 it started taking steps towards establishing transparent management by setting up a committee. Under 1988 Cabinet Order Article 24 and its 1999 revision, the registration of financial statements was made mandatory for companies with gross assets in excess of 25 billion Rupiah. The content of the reports is to comprise balance sheets, profit-and-loss accounts, cashflow calculations, credit and debt table including bank borrowing, and shareholder composition. The public certified accountants in charge of auditing must conduct the reporting procedures and take responsibility for the content of their reports. Contraventions are punishable by fines and suspension of operations.

IMF, World Bank and US government have been interested in the corporate governance of large Indonesian companies, but it is assumed that they were not deeply interested in the Company Act itself. One ground for this assertion is that the ordinances described below, which have the potential for the government to encroach on the freedom to establish companies, did not draw any serious reaction. The two ordinances concerned were issued in 1998 as legal substructure to the Indonesian Company Act of 1995. They govern company trade names and the mergers and acquisition of companies. There is no problem with the content of the ordinance, which states that trademarks must not be identical or highly similar to famous trademarks, and must not consist solely of a place name, but the procedure for judgement of whether or not a trademark is proper rests on receiving approval from the Minister of Justice before the company concerned is established. In some cases, that approach could cause problems, because it could lead to government intervention in the foundation of companies. It goes against the concept of standing rules that a company is established by simple recording not by approval procedure.

Ordinances concerning mergers and acquisitions of listed companies depend on the rules of securities exchanges, and the special resolutions on mergers and acquisitions passed by shareholders' general meetings (resolution passed by shareholders holding three quarters of voting share, where a quorum of shareholders is present) do not apply. The special resolution matter is more stringent than the two-thirds majority requirement for passing a special resolution for changing articles of association. It gives strong protection to the rights of the small numbers of shareholders in non-listed companies. In foreign-affiliated manufacturing companies where a majority of funding is from foreign capital (Japanese-affiliated companies are numerous in that category), the interpretation is that this situation restricts the

management rights of the foreign side. The terms of special resolution matter are stipulated by the Company Act, which means that they cannot be changed by government ordinance. An amendment of the Company Act would be required to change the terms. Altered or new articles of association due to mergers and acquisitions must also be approved in advance by the Minister of Justice, which appears to leave scope for government interference. Article 5 of the ordinance stipulates that in the case of amalgamation and also of acquisition, care must be taken to safeguard the rights of the creditors. This stipulation also raises concerns over potential government interference on corporate activity. In Japan there are required procedures for the protection of creditors in the case of amalgamation, but such procedures are not needed for acquisitions\*<sup>3</sup>, which are covered by the Indonesian ordinance (acquisition is equivalent to the transfer of all, or of a substantial part, of a transfer of business). When business is to be transferred, debts cannot be avoided unless the transferred company lets the transferee company receive debts upon approval of creditor\*<sup>4</sup>. In Indonesia most of the creditors' rights to be protected are unclear, and the regulations make no distinctions between amalgamation and acquisition.

## 2. INDONESIA'S ACCOUNTING STANDARDS AND COMPANY ACT

Under Indonesia's Company Act, financial statements must be prepared according to the Indonesian corporate accounting rules (formally explained in Article 58, Clause 1 of the Company Act). The Indonesian Accountants' Association, which has the power to determine the accounting rules, decided in 1994 to adopt the International Accounting Standards set by the International Accounting Standards Committee (IASC). Therefore IAS No.1, which is the

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\*3 When a Japanese company is acquired, the controlling share is transferred as well as the transfer of business. The transfer of the controlling share is an acquisition method which does not require a resolution of the shareholders' general meeting caused by the TOB etc. of a listed shares. The conditions for a general meeting resolution on the acquisition of a listed company are laid down in the regulations on securities transactions. Thus the transfer of the controlling share appears to be exempt from the terms of the ordinance.

\*4 Yujiro Takahashi, "Company Act Arguments and Proofs", Jiyukokuminsha, 1997, p.181.



IASC “Framework for the Preparation and Presentation of Financial Statements”, became Indonesia’s corporate accounting rules “Financial Accounting Standards (PSAK)” No.1 without modification\*<sup>5</sup>. Under the Company Act, audits by certified accountants are required for the balance sheets and profit-and-loss statements of banks, insurance companies, investment trust companies, bond issuing companies, and public companies but even for those the linked balance sheets are not subject to audit.

In Japan each company can determine its own accounting rules with reference to Japanese accounting rules, and the Japanese rules do not have to match international accounting standards. Thus the formulation of the Indonesian Company Act in 1995 can be viewed as an attempt to apply international standards directly to Indonesian companies. They appear to have taken the approach that there is no need to prove that audits have been made by certified accountants.

It is very interesting to note that the 1998 ordinance on amalgamation and acquisition stipulates that shareholders general meetings of the company initiating the merger or acquisition must receive reports from independent certified accountants on whether the accounting ledgers of the company being merged or acquired have been maintained correctly according to the Indonesian corporate accounting rules. This rule recognizes that in circumstances where window dressing of accounts is common, the shareholders of the company initiating the merger or acquisition can suffer from embellished accounts presented by the target company.

The Company Act includes the following provisions:

- The invitations to the shareholders’ general meeting do not have to be accompanied by a copy of the

- financial statements (those who wish to see the accounts can state their wish and have a copy of the statements forwarded to them free of charge).
- Minority shareholders right is only recognized if they hold 10% or more of the shares.
- Second-round shareholders’ general meetings can be held which do not require a quorum.

From the point of view of checking on management, these stipulations can be regarded as lacking rigor.

Another Indonesian characteristic is that each individual director represents the company. There is no system for a board of directors and a managing director. This is partly because the Indonesian Company Act regulates the whole range of limited liability corporations regardless of their size, but it is troublesome to have to specify the board of directors and its delegacy in the articles of association for each company. In particular, the setting of future accounts receivables as collateral under the 1999 Fiduciary Transfer Act means that measures must be taken in Japanese joint venture companies to prevent independent action by directors, because otherwise Japanese joint ventures could be acquired against the wishes of the majority shareholders.

Indonesia’s Company Act is certainly a law for limited liability corporations, and corporate governance seems to be advancing due to the fact all joint-stock companies shall be obligated to appoint an auditor, regardless of their size. However, the ability of auditors was never questioned. International accounting standards, whether they are the IAS standards set by the International Accounting Standards Committee (IASC) or the standards set by the US Financial Accounting Standards Board (FASB)\*<sup>6</sup>, are published in a series of numbered versions to suit different purposes. Whether it chooses to use all the numbered versions or only some of them,

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\*5 Kazuo Hiramatsu etc., “Indonesian Accounting”, Chuo Keizaisha, 1998, p.54. Indonesia’s “Financial Accounting Standards” is made up of a total of 35 accounting standards. Apart from nine industry-specific accounting standards, the other 26 are taken from the IAS without modification. This point is explained further on p.78 and later pages of the above book.

\*6 “The Dynamism of Accounting Systems”, Kunio Ito, Iwanami Shoten, 1996, p437~439 makes a point that can be summarized as follows. The similarity to IAS and FASB is high, at 92% (in 1990 the figure for Japan was 68%). In many cases the session of IOSCO, which determines the IAS, was unanimous, but no conclusion could be reached due to US opposition. As a result, the IAS is moving ever closer to the FASB accounting standard in an effort to gain US approval more easily. The international harmonization of accounting standards by the IAS is characterized by the process of indirect worldwide permeation of US disclosure standards and accounting standards, which have avoided the IAS.

Indonesia can say that it is employing international accounting standards.

Cabinet Order Article 24 (implemented from 1999) specifies the content to be included in reports by all companies with gross assets over 25 billion Rupiah. In fact, this content differs from the financial statements specified in IAS No.1. The difference is that the specified report content does not include a calculation sheet to show all changes in shareholders' holdings, and those changes resulting from causes other than capital transactions with shareholders and allocations to shareholders. This kind of calculation sheet is equivalent to comprehensive profit statement in FASB. Indonesia's accounting standards may not be exactly the same as the IAS, but if they are described as international they are incomplete without such a statement in FASB. The calculation sheets would show items such as re-evaluation profit or losses such as reserve for retirement community and financial products, and deferred exchange fluctuation account, which are not reported in the profit-and-loss calculation sheets. If the IAS is not displayed in accordance with IAS No.1, the reason must be explained and exceptions are only granted for very rare exceptions. According to Article 58, Clause 2 of Indonesia's Company Act, the reason must be described when the use of Indonesia's accounting standards could be incompatible with the current state of a company's financial accounting. It could be interpreted as saying that if Indonesia's accounting standards, which are in line with international accounting standards but allow considerable deviation, are not used, there is no need to state the reason.

Indonesia's No.1 accounting standard describes accounting policies for the preparation of financial statements. It can be interpreted as meaning it is acceptable for the nature of financial statements to differ from the stipulations of IAS1.

The author has doubts over why the disclosure of financial information depends on amendment by ordinance rather than on amendment of the Company Act. It is amendment by ordinance rather than amendment of the law, thus it cannot really be described as legal reform. The revision may be adequate for securities investments by foreign institutional investors, but an opaque reform of

company management (which forms an important element of managerial innovation) is debatable, if one takes the position that reform is required for structural problems that impede economic growth. It is not a reform that simply aims to be convenient for foreign securities investment in large-scale listed companies.

For example, suppose a small or medium Japanese company made a direct investment to become an investor with minority equity in a joint venture. In Indonesia all foreign-capital joint ventures must be established in accordance with the Company Act. It would certainly be difficult for investors on the Japanese side to gain an accurate grasp of the company's financial position solely from accounting standards according to the Company Act. It would not be possible to fully check on management by the local leading shareholder, and if the Japanese side is only providing production technology it cannot expect to make an investment profit. Therefore the Japanese side would choose to use a 100% foreign-capital company to extend its operations into the country concerned. Even if the Japanese side aims to cooperate with policies to nurture peripheral industries, as demanded by the local government, full transfer of managerial and technological innovation is not possible through a 100% foreign-capital company. Therefore if the factory workers change jobs, that is the end of the transfer. Managerial innovation cannot be transferred in the absence of a partner from the counterpart country. It is probably wrong to criticize 100% foreign-capital companies as economic enclaves, but they create a situation in which they can easily turn into economic enclaves as the end result, and bear the brunt of local nationalism. It is at least possible that this tendency could become stronger following the reform of the Company Law. If the reform of the Company Law is no more than a revision of share trading rules aimed at large-scale listed companies, it will create an environment in which the company information gained through securities trading rules will cause foreign securities investors to sell their shares on the market and withdraw. Foreign-affiliated companies created with direct investment and not listed on the market will remain. From the local point of view, foreign securities investors and foreign-affiliated companies set up with direct investment are foreign capital. This author's

assertion that cooperate governance as well as company information disclosure are also necessary for small and medium companies is prompted by the fear that this situation could arrive.

### **3. THE THAI PUBLIC LIMITED COMPANY ACT**

The 1992 Thai Public Limited Company Act stipulates that such companies must have boards of directors, but it is recognized that corporate governance still has a strong tendency towards family domination and the regulations described below appear to be acting to strengthen that tendency. The board of directors can entrust one or more directors or other persons the authority to run the company freely. On the other hand, the auditor only has the authority to audit the balance sheet and income statement and, in contrast to Japan, is not empowered to attend board meetings. Minority shareholder rights are only accorded to shareholders with holdings of 5% or more. Furthermore, if the shareholders' general meeting ends in failure in short of quorum, a second-round meeting can be held without a quorum. The Company Act does not include any stipulations on accounting standards. The only document to be notified publicly is the balance sheet, and there is no system equivalent to the one in Japan for creditors and shareholders to scrutinize calculation documents and related statements. Accounting standards are specified by the Thai Stock Exchange Supervisory Commission (SEC) which sets standards as stipulated by Thai Certified Public Accountants and Auditors Association. The standards follow the International Accounting Standard, the American Institute of CPAs and the FASB. However, the various types of window-dressing settlement seemed to be a controversial topic.

In the same way as in Indonesia, the content of Thailand's amendments to its Company Act has not taken up for discussion, because the point at issue is the problem of corporate governance in listed companies. The strengthening of the Thai Stock Exchange Supervisory Commission (SEC) has led to a review of accounting and auditing systems. The points which have generated interest are the establishment of audit boards comprising three

external directors (of whom one must have knowledgeable in accounting and finance. The company should also have its own internal auditor, which means that an appropriate division of roles between the two should be devised, but the details are left to each individual company), and the protection of the rights of minority shareholders. In that case, it would have been appropriate to amend the Securities Exchange Act, but no such amendment has been made. Instead the method used is revision of the SEC rules. The situation in Indonesia, where ordinances are used in roundabout ways to make amendments, seems far removed from the Thai approach of using legal reform to excess as the means to strengthen company information disclosure. If legal amendment had been used, opposition was expected from business groups in the parliament, and particularly in the upper house, as was the case with the amendment to the Insolvency Act, preventing the passage of the reforms. Therefore, if self-regulation through market listing standards was used to make the amendment, this would be an amendment which lowers the anticipating possibility of legislation. One view is that if voices for the strict implementation of the law were ignored, foreign institutional investors would stop investing in the stock market and exit function would start to work, thus it would be sufficient to keep the normative nature of the law low. However, that approach was open to criticism that the reform of the fragile corporate sector was no more than "a measure to protect indirect investors".

In Thailand, direct investment in the form of establishing a company under the Thai Public Limited Company Act is rare. The normal method is to establish a limited company under the Civil and Commercial Code. That is certainly an easier way to start a company, and it involves less disclosure of company information. The preparation of ledgers and financial statements is mandatory, but auditing by certified accountants is not required. The drawback of this simplified system is that it involves a higher level of risk for foreign direct investors, because there is more scope for window-dressing, tax evasion and arbitrary use of managerial authority without reference to joint venture contracts. The simple argument that everything will be determined by the balance of power between the investors depends to a large extent on

the minimum level that is set for disclosure of company information. Information disclosure based on the Public Limited Company Act appears to have turned out to be too stringent, taking into consideration of benefits of indirect investors. Legal reforms related to Thailand's Company Law brought about severe results for direct investors. Privatization Act for State-owned Enterprise was taken as Thai Company Law related legal reform. However, the author is of the opinion that the application of the Act's procedures to state-owned enterprises that were already scheduled for privatization would actually delay the privatization process.

In Japan the Commercial Code sets items to be calculated by company limited by shares, and stipulates accounting standards for each section of the calculation documents, which makes window-dressing of accounts inherently a violation of Commercial Code. In Thailand the maximum sanction that can be applied in such cases is delisting treatment. This is a problem because it does little to motivate Thai managers to disclose information fully and pursue their management activities to attract investors. The Thai situation is not in line with the direction of the world, where voluntary information disclosure with an emphasis on investor relations raises the company's market value. Amendment of the Alien Business Act has increased the range of fields open to direct investment by foreign capital, and that coincided with the substantial recovery of the Thai economy in 1999. This combination is perceived as creating a good opportunity to move into Thailand, but careful consideration of the above points is required.

#### **4. COMPANY ACTS IN MALAYSIA AND SINGAPORE**

The preceding sections explained that corporate governance in both Thailand and Indonesia has yet to reach an adequate level. Those countries follow the "shareholder model", which holds that ownership of a company is in the hands of the controlling shareholder. There appears to be little awareness of Japanese-style corporate-capitalistic thinking that a com-

pany belongs to its managers and core employees, nor idea that a company belongs to its shareholders, including minority shareholders. There is certainly little scope for acceptance of the "interested parties" model, in which a company is formed by the network of checks and balances between management, employees, creditors, consumers and local community.

On the other hand, companies in Malaysia and Singapore are different from their Indonesian and Thai counterparts. There is certainly still a strong belief that a company belongs to its controlling shareholder, but the government is also regarded as a major interested party, such that its intentions cannot be overlooked. In Malaysia, under the Bumiputra policy, it is said that the state-owned investment trust offered high returns and allocated a 30% quota of the shares to Malaysians. The government has kept the prices of listed shares low, which appears to enable it to guarantee high returns. The government pursues the Bumiputra policy by which it guides share and realty prices to some extent. Observing this policy, foreign capital poured foreign currencies into the share and realty markets, inciting speculation in both shares and realty. The view became widespread that profitability was reduced as a result, and therefore the currency crisis that began in Thailand would also infect Malaysia, prompting a rapid withdrawal of foreign currency by foreign institutional investors. This became a self-fulfilling prophecy, and Malaysia also fell into the currency crisis.

Malaysia and Singapore differ from Thailand and Indonesia in that they take the company law of Common Law approach, by which dividends are decided by the board of directors rather than by the shareholders' general meeting. Companies do not belong to their shareholders, and the board of directors aims to further the company's development by a balance of earning retention, external outflow by payment to shareholders, and taxes paid to the government. As Malaysia was a British colony, there is the position that emphasizes judicial precedent as a legacy of Anglo-American law and there is the Equity approach. While in Malaysia keeping aware of the Indian Chinese under a "Malaysian first" policy, Chinese companies kept their distance from the government in the process of reinforcing their economic dominance.

Singapore is a small country, and companies cannot survive on the domestic market alone, thus they had to eliminate inefficient management in pursuit of international competitiveness. This led to the approach of cooperation between government-capital companies and Chinese companies as a means of reducing waste.

When doing business with companies from these Southeast Asian countries, information disclosure should be made a precondition for trading. If disclosure is not forthcoming, the following steps should be taken:

- Charge a high premium (this is particularly necessary when dealing with Thai and Indonesian companies).
- Shorten the duration of the transaction (Malaysian companies tend to take the same approach as Indonesian companies, under the conditions that no conflicts arise and the government does not know).
- Make oneself the controlling shareholder.
- Team up with Japanese-affiliated companies which have Japanese companies as the controlling shareholders.

In order to obtain information from the overseas side, the Japanese side must also disclose information. It is necessary for Japanese and Japanese-affiliated companies to give importance to investor relations. There is the concern that the company making the disclosure might get taken over, but a company can disclose sufficient information while preserving the confidentiality of its secret information. Disclosing the fact that secret information exists can actually increase the company's market value.

Management must make the judgement that if the market valuation of their company rises and they can sell their equity portions for several times its current value, that is a successful withdrawal Professor Michiyo Hamada, Nagoya University says the following: "If a company holds dormant assets and surplus assets of low profitability, they must take the initiative to sell those assets and reduce the surplus funds through dividend allocations or the purchase and redemption on shares. By adjusting the quantity

of their stocks of assets to match their earnings flow in this way, it would be better to revive the rate of capital turnover for their shareholders. That is the most effective defense against corporate raiders" \*7. The local reputation of overseas companies can be learned from local Japanese and Japanese-affiliated companies as part of the information gathering process, but the source of such information must be checked to see whether it comes from newspapers, information magazines, rumors or other sources, as a way of enhancing the ability to evaluate information.

## **CHAPTER V THE LEGISLATION OF VIETNAM'S COMPANY LAW**

### **1. COMPANY LIMITED BY SHARES AND LIMITED LIABILITY COMPANY**

The basis law for doing business in Vietnam is the Company Law, which went into effect from January 2000. The previous law regulated companies depending on their ownership, but companies have now been reclassified according to their organization. The previous ownership-based classifications were used with the State-owned Enterprise Law, the Foreign Investment Law, the Individual-managed Company Law and the Cooperative Association Law. The Company Law, which was based on organization, regulated company limited by shares and limited liability company.

The more recent Company Law regulates four types of companies: individually-managed companies (the kind that are commercially registered in Japan as individual businesses), partnerships (in Japan, partnerships can be further classified into unlimited partnerships, limited partnerships), limited liability company (limited liability company as defined by Japan's Limited Liability Company Law) and company limited by shares. This arrangement is, in itself, very straightforward.

However, the only laws that were repealed with

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\*7 Michiyo Hamada "Commercial Code", Iwanami Shoten, 1999, p223

the implementation of the current Company Law were the old Company Law and the Individual-managed Company Law. The old company laws based on ownership types (the State-owned Enterprise Law, the Foreign Investment Law and the Cooperative Association Law) are still in effect, which complicates matters. All companies limited by shares established under the Company Law issue shares and fall into one of three categories, as listed below, which are very clear <sup>\*8</sup>.

- (i) Companies which receive investment from Vietnamese capital, either individuals and companies (includes companies under a wide range of ownership types, but does not include organs of the state).
- (ii) State-owned enterprises established under the State-owned Enterprise Law or companies with an organ of the state as one of the investors.
- (iii) Companies with foreign capital not exceeding 30% of the total capital.

The “foreign capital” referred to in (iii) means foreign persons, foreign companies established under the foreign law, and also the portion of a Vietnamese company established under the Foreign Investment Law which corresponds the share portion funded by the foreign side (in the case of 100% foreign-capital companies the entire nominal capital of the company, and the value contributed by the foreign side in the case of joint ventures with local companies).

Looking at limited liability companies established under the Company Law, there are some that fit into (i) and (ii) above, but none that fit into (iii). As a fourth group (iv), there are limited liability companies established according to the Foreign Investment Act. However, the interpretation of the law is that the rules for limited liability companies contained in the main Company Law are not applicable to foreign-capital companies established under the Foreign Investment Act. The reason is that for joint ventures there are strict conditions placed on the resolutions of boards

of directors to ensure that they reflect the views of the Vietnamese investors, but for limited liability companies a single director is adequate, with no need to set up a board of directors. Furthermore, capital reduction is permissible for limited liability companies, but it is not for joint ventures or for 100% foreign-capital companies. When discrimination between domestic and foreign capital becomes a problem in negotiations for WTO membership, the plan appears to be to transfer the company types from limited liability companies established under the Foreign Investment Law to join those established under the Company Law. Thus joint ventures would become limited liability companies with two or more investors and 100% foreign-capital companies would become limited liability companies with only one investor. The branches of foreign corporations permitted to do business in Vietnam (there are some examples of bank and insurance company branches) are able to invest in joint ventures under the Foreign Investment Act and in limited companies under the Company Law, it appears that they will not be able to invest in limited liability companies under the Company Law for the time being. That is the case because the branches of foreign corporations are not companies established on the basis of the Foreign Investment Act.

## 2. INDIVIDUAL-MANAGED COMPANIES AND PARTNERSHIPS

Individual-managed companies established under the Company Law come under category (i) with a single individual as the unlimited-liability investor. That is not a form of company permitted in Japan under the Commercial Code, but the concept under taxation law is close to the individual business. However, the individual business exists regardless of the existence of material assets, while an individual-managed company is established on the basis of its material

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<sup>\*8</sup> The Vietnamese Company Law does not include any regulation limiting the foreign capital equity investment share to 30%, but the Foreign Investment Law says that it applies to companies with foreign capital ownership of 30% or more. Article 18 of China’s Company Law says that articles concerning limited liability companies other than those stipulated in laws on foreign direct investment (foreign-affiliated joint venture companies, 100% foreign owned companies and Sino-foreign cooperative enterprises) shall be applied to limited liability companies with foreign capital. If national treatment is requested, Chinese Company Law shall be amended, while the Vietnamese Company Law shall not be amended.

assets. Under the Vietnamese Commercial Law, there is the concept of the small individual proprietor (a street vendor, or under the Japanese Commercial Code, a small tradesman), but that should be regarded as referring to a shop with a larger scale of physical assets. In contrast to a limited liability company with only one investor, the investor in an individual-managed company is also the manager. The investor or investors in a limited liability company nominate the managers of the company, leave the management in their hands, and collect dividends from the profits. The investor of an individual-managed company, who is not also the manager, determines who should be paid to manage the company and the manager receives remuneration regardless of the profit generated.

Partnerships only exist in categories (i) and (ii). There is no form of partnership in which foreign capital is allowed to invest. However, in future Anglo-American law and accounting firms may demand the right to register to do business in Vietnam under the same form of partnership they use in their home countries. Partnerships with a mixture of unlimited liability and limited liability partners and the character of a corporation are a valid form of company for realty development and BOT projects. Business cooperation contracts regulated by the Foreign Investment Law do not have corporate characteristics and are therefore not partnerships.

Looked at in that way, the Company Law is a law under business register based on the material assets provided by the investors and pursues business activities, and the profits or losses generated by that activity are distributed between the investors depending on whether they are limited liability or unlimited liability investors.

The fact that there is no point of overlap between the Company Law and the Cooperative Association Law is considered to allow the existence of cooperative associations that are not based on the material asset as equity investment by labor force.

These awkward classifications are used for two reasons. One is that for the purposes of WTO membership, there must not be discriminatory treatment between investment of foreign capital and investment of domestic capital, thus the law must not include Company Law based on forms of ownership.

The other reason is that the State-owned Enterprise Law and the Cooperative Association Law must be maintained in order to preserve all people's ownership (state ownership) under the socialist system.

### **3. MINORITY SHAREHOLDER RIGHT AND MANAGEMENT AUTHORITY FOR THE INTRODUCTION OF FOREIGN CAPITAL**

Legislation on Vietnam's company limited by shares is based on the policy of keeping overall foreign capital with minority shareholders below 30%. Therefore to attract foreign investment Vietnam has relatively strong protection of minority shareholder right. A shareholder holding 10% or more of ordinary shares, or one holding less shares, where allowed by the articles of association, gains the following rights:

- (i) They can nominate one member of the board of directors (the regulations specify that the number of directors be 11 at most and the number of shareholders be at least 11. If ten of the 11 shareholders each hold 10% shares they can nominate one director each, and the majority principle comes into play) and one member of the audit board (3~5 members).
- (ii) They can demand a shareholders' general meeting.
- (iii) They can obtain a listing in the shareholders' register.

The minority shareholder right at limited liability companies in Vietnam is vested only to those with investments exceeding 35% of the company in the form of being granted an opening right of shareholders' general assembly.

Other than minority shareholders, interested parties are entitled to go to the business registry and pay to obtain a copy of the annual financial statements for a company limited by shares. That is an effective method for investors, and particularly foreign investors, to obtain information when considering future stockholding. This kind of legally regulated system for disclosure of financial statements exists in Japan as well, but there is no such system in Thailand or Indonesia. When this author proposed the introduction of such a system at a Legal System Reform Seminar in Jakarta, Indonesia in October

1999, the counterargument was put forward that the disclosure of company financial statements was determined by the balance of power between the parties involved. This situation leads to an extreme asymmetry of information and is very likely to raise transaction costs, but apparently some Indonesian managers feel that there is more of an advantage in not disclosing information. That attitude only serves to heighten the impression of managerial opacity.

However, the mechanism that even minority shareholder right is exercised, the management authority can hardly be overridden by managers nominated by controlling shareholders, is formed by allowing voting right preferred stocks<sup>\*9</sup> and dividend preferred stocks. This is because even where the controlling shareholder is the state sector and the company has become a company limited by shares through equitization, the previous corporate governance is continuing. So Vietnamese never use the word of privatization. One case which can be envisaged is that in the transition from state-owned enterprise to company limited by shares, the previous state-owned enterprise which was under the jurisdiction of the governing ministry receives voting right preferred stocks, and companies and individuals in the Vietnamese private sector receive dividend preferred stock without voting right or common stocks. At the inaugural general meeting, articles of incorporation acknowledging those share types would be approved. If foreign investors bought common stocks or dividend preferred stocks under a later capital increase, they would not be able to force amendments of the articles of incorporation. There is no limit to the proportion of the total issued shares which an equity investor can receive in exchange for a one-time equity investment of goods (investment in kinds), thus there is no comparable price for state-owned enterprises in the state sector, where equity investments can be made with land-use rights and technology expertise. As a result equity investors are

very likely to be able to acquire large stock equity. Foreign investors making equity investments in foreign currency may suffer from currency exchange losses.

Voting rights by the issue of stock-in-kind can lead to inadequate checking functions in management, and is a dubious practice from the point of view of corporate governance. It should be used sparingly, as it goes against the principle of equality of shareholders. However, the Vietnamese Company Law does not stipulate any limit on the issue of stock-in-kind. The only stipulation under the Company Law is that voting right preferred stocks are only valid for three years from the business register, after which time they become common stocks. There is not mention of any limit on how many common stock voting rights one voting right preferred stock counts for. For example, there are no limits on issues of dividend preferred stocks or redemption preferred stock.

By issuing large numbers of dividend preferred stocks and redemption preferred stocks, managers can draw in substantial amount of funding without opening themselves to any managerial intervention. The voting right preferred shareholders have an excessive influence on how those funds are used, while the holders of dividend preferred shareholders may and redemption preferred stocks have absolutely no say in the matter. Voting right preferred shareholders may create the risk of opaque cronyism with the management. The rule in Japan is that shares without voting rights in a company limited by shares cannot exceed one third of the total shares issued (Japanese Commercial Code, Article 242, Clause 3). In South Korea at the start of the 1990s the law was amended to allow the issue of preferred shares without voting rights up to 50% of total paid capital, as a means of improving the debt positions of the conglomerates. Thus the opinions of minority shareholders ceased to be reflected, and there was unfair trading in the issue and transfer of those shares. These problems led to a

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\*9 These are preferred stocks which have preference over common stock in voting rights, which is an unusual system in the world. The degree of preference is set in the articles of association. They are converted to common stocks three years after business register, but they are non-transferable. The likely holders of such shares are state agencies or state-owned enterprises which make equity investments in company limited by shares. In China, state stocks and corporate stocks are non-transferable, but they are a problem because they have no basis for non-transferability in the regulations stipulated by the Company Law or other regulations.



further amendment in 1995, by which the limit for the issue of preferred shares without voting rights was returned to 25% \*<sup>10</sup>.

Issue of shares for less than face value is not permitted, which must limit the limited companies able to use employee stock ownership plan (ESOP). That might mean that wage increases would have to be used instead to build workforce morale and skills. In October 1999 Vietnam introduced the same 40-hour work week as China. That will lead to increased labor costs in Vietnam, which will tend to reduce the country's international competitiveness. The employee stock ownership plan means that although the workers who sell their labor do so for a slightly lower price, they can make a capital gain as shareholders on the future value of the company. In 1996 and 1997 the Communist Party called for widespread introduction of employee stock option plans, but it also pressed for a system whereby the stocks would be bought using finance supplied by the state-owned commercial banks. As a result, the government did not adopt the measure, which would have caused a fiscal deficit. There is talk in Vietnam of the need for a state subsidy, because most Vietnamese people are poor. However, the issue is not one of poverty but of fostering the independent spirit needed for them to generate wealth by their own efforts. That spirit is one precondition for Vietnam's economic development.

In Vietnam, where the establishment of a stock exchange market is well overdue, the managers of state-owned enterprises and the officials with jurisdiction opposed equitization on the grounds that it would intensify interference in managerial authority. At the meetings of board of directors, which take place at least once in each quarter, the chairman and the president, who handles day-to-day management are chosen. It is permissible for one person to hold both posts. Provided the chairman is not specified in the articles of incorporation (charter) the representative of the company, the president is the legal representative. Therefore where the controlling shareholder belongs to the state sector, it would rather have the practical

authority to nominate the president rather than the chairman. There are very few pure private capital-owned companies limited by shares in Vietnam.

#### **4. REPURCHASE RIGHT OF STOCKS AND COMPANY INFORMATION DISCLOSURE**

Companies in Vietnam that are nominally companies limited by shares commonly have organizations similar to small and medium businesses, in which the controlling shareholder and the manager are integrated. Repurchase right of stocks is typical in such cases. Repurchase right is attracting attention as a factor that is continuing to stimulate the US stock market, but in Vietnam it is likely to be used as a means of maintaining managerial authority. The limit of repurchase right is 30% of common stocks, which means that it is possible to buy back all of the stocks gained by a foreign investor through equity investment. There is no need to pay a special premium price for the repurchased stocks, because the market price is set as the upper limit for the buy back price. A shareholders' general meeting is required if the repurchase exceeds 10%, but below that limit a resolution of the board of directors is sufficient. A court precedent in Germany allows a system for cases when an antagonism arises between shareholders that is difficult to resolve. Each equity investor in a limited liability company can repurchase an amount equivalent to its equity share. No such system exists for limited liability companies in Japan. The Japanese Commercial Code has regulations for unlimited partnerships and limited partnerships in cases where a partner retires (when the investor voluntarily withdraws equity) or is dismissed (the partner's equity investment is closed against the partner's wishes). Professor Masamichi Ohno of Tsukuba University argues for legislation to the effect that retirement and dismissal should be permitted in limited liability companies and in closed type companies limited by shares, which are a kind of small or medium business\*<sup>11</sup>. The deprivation right of shareholder's qualification of minority

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\*10 Yukiko Fukagawa, "Structural Adjustment and the Formation of Corporate Governance in East Asia", Aoyama Collection of Theses, 1999 December issue, p71.

\*11 Masamichi Ohno, "Essays on Small and Medium-Sized Company Law", Shinzansha, 1997, p29~63.

shareholders is granted to the board of directors and the shareholders' general meeting of a company limited by shares in Vietnam.

Ordinarily the repurchase right is accorded to minority shareholders who oppose a company amalgamation.

Those who cannot accept the change in their stock value are granted the right to retire. In Vietnam, there are rules for the rights shareholders can employ when the decision is taken by the shareholders' general meeting to amend the articles of association (such as entering into amalgamation) which stipulate the shareholder's rights and obligations, or to pursue corporate restructuring (procedures to apply for insolvency and then search for new financial backers to rebuild the company). The company's repurchase right can be used when minority shareholders oppose the company's management policies. The anticipated case is that minority shareholders could voice their opinions to the management on some issue, and make an unexpected exit if the management does not respond to their satisfaction. That mechanism means that while the state sector in Vietnam retains managerial rights, it will be biased towards management that is acceptable in its own eyes. That kind of managerial behaviour is clearly not good corporate governance. In Japan the expulsion of a partner requires a majority decision by the other partners, followed by judgement. Furthermore, in cases by common opinion in Japan, the package expulsion of multiple partners is not permitted <sup>\*12</sup>, but expulsions are easier in Vietnam because there are no such regulations there. Multiple shareholders can use expulsion to eliminate a dissenting minority shareholder. There are also no regulations on third-party responsibility of the board of directors and on derivative actions of the kind which exist in Japan.

The Company Law contains no regulations on the nature and content of financial statements or the accounting standards which should be used. These deficiencies diminish the legal predictability of corporate information disclosure. There are also problems with the audits conducted by the 3~5-

member audit boards. Audit board members are nominated from among the minority shareholders, the chairman of the audit board is an individual shareholder, one of the auditors is an accounting specialist, and the audit comprises a finance audit and a business audit. With these elements, the audit appears to be complete. However, there is room for argument over the fact that audits by accountants are only provided for when specified by other laws, and the audit opinion can be presented with reservations. The text of the law says that the audit has the proposal right for business improvements, and that the business audit must cover correctness and credibility, while the finance audit of the accounts ledgers must cover credibility, correctness and legality. The finance audit of the accounting ledgers and financial statements must cover credibility, correctness, legality and any reservations on those points. In Japan, opinions on financial statements can be judicious opinion, injudicious opinion, judicious opinion with qualification or forbearance of opinion. However, if procedures in contravention of accounting standards are not viewed as serious matters, judicious opinions will always be recorded in the audit reports<sup>\*13</sup>. Qualified opinions are viewed as a measure to avoid misleading financial statements by interested parties, but in some cases they may cause problems with judgement of the seriousness of problems. In Japan, forbearance of opinion differs from qualified opinion, but no standards have been produced in Vietnam for the writing of qualified opinions. The law also states clearly that when the board of auditors demands information and documents from the board of directors, individual directors and managers, the request can be denied following a decision by the shareholders' general meeting.

Thus company limited by shares appears to give very advantageous treatment to large shareholders (the state sector), but nevertheless, little progress is being made in the equitization of state-owned enterprises. Faced with this situation, some within the government are now considering converting state-owned enterprises to limited liability company with a sole

\*12 Kunio Komurase, "Annotated Company Law (1), Supplementary Edition", 1980, p.326-332.

\*13 Yoshiaki Ozawa, "Study of Points at Issue in Accounting Theory", Chuo Keizaisha, 1996, p.122-131.

shareholder. There is cause for concern that they are maintaining managerial authority even while they lack firm confidence in the managerial ability of the managers of state-owned enterprises.

## **CHAPTER VI COMPANY MERGER DRAFT LAW IN CHINA**

### **1. REFORM POLICY OF STATE-OWNED ENTERPRISES THROUGH MERGERS**

Until around 1998, China had been emphasizing bankruptcy as a key element of its state-owned enterprise reform policy. However, bankruptcy leads to unemployment, community breakdown and a worse impact on state finances. As a result, the emphasis has shifted to company mergers since 1998. For over three years the State Council, Economic and Trade Committee has been working to prepare a draft company merger draft law (a draft law is equivalent to an ordinance. It has yet to be enacted as a law).

The Japan-China Economic Law Seminar opened in Beijing in January 2000, and Mr. Chen Li Jie, who covers legislation in China, presented the paper "Research into the Legal Problems of Company Mergers", giving the author the opportunity to serve as a commentator for the paper. The paper attracted attention as a legal system reform related to the Company Law, and therefore the author has analyzed it from the point of view of company information disclosure, and made some comments (2~5 below).

### **2. THE ADVANTAGES OF CONVERSION TO A WHOLLY-OWNED SUBSIDIARY THROUGH PURCHASE OF ALL STOCK**

In addition to mergers and amalgamations, the draft decree for amalgamation aims to regulate the creation of wholly-owned subsidiaries through the purchase of all stock. The advantages of that method are as follows:

- (i) The legal procedures for a merger or amalgamation, such as the special resolution of general

meeting, creditor protection procedures and cancellation or revision of company registration, can be omitted.

- (ii) The intangible property and resources of the purchased company can be used.
- (iii) The risks of the purchased company are reduced.
- (iv) The special tax breaks for mergers and amalgamations can be used.
- (v) The rules fill a void in the law concerning the purchase of all stock in a non-listed company. The author considers the following to be further advantages:
  - (vi) Purchase of all stock fulfills the same role as reconstruction under the Chinese Bankruptcy Law. A company on the brink of bankruptcy can be inherited as a complete entity, preventing the loss of good staff and thereby keeping technology and expertise within the company.
  - (vii) Mergers can be made freely between different forms of company. Unlimited liability companies and limited liability companies can merge in a way that is impossible in Japan.
  - (viii) Making two companies into one is impossible when one of the sides involved is overburdened with debt, but it can be interpreted that if purchase of all stock is used, even a company which effectively has excessive debts can be made a wholly-owned subsidiary. Furthermore, the value of assets is approximately zero, which means the delivered money due to merger can be reduced.

### **3. THE SHORT-FORM AMALGAMATION SYSTEM, WHICH ELIMINATES THE NEED FOR A SPECIAL GENERAL MEETING RESOLUTION CONCERNING PURCHASE OF ALL STOCK**

Mr. Chen proposed that the standard for permitting (i) short-form amalgamation should be that the nominal capital of the merged company should be 10% or less of the nominal capital of the company making the merger, but the author commented that the standard should be based on 10% of net assets. If the merger is accomplished without gaining the approval of the shareholders at a shareholders' general

meeting of the company making the merger, the shareholders' benefit will not be served if at least the net asset value of the acquired company's finances are not accurately known. The merging company bears all risks associated with the acquired company's personnel, technology, quality of assets, and reputation. If it also bears financial risks it will be difficult to find a merging company. For (ii) merger with a subsidiary the standard should again be that the merger should involve less than 10% of the parent company's net assets, rather than the proposed standard that the parent company should be in control of 90% of the subsidiary's assets. Measures taken to reduce the cost of the merger and enhance its efficiency should be considered so as to help enhance the efficiency of the merged company's business. If there has been a shareholders' general meeting, their approval has been obtained, but with short-form amalgamation, which omits the decision, the shareholders may disapprove. In some cases a subsidiary may be able to earn large revenues while its nominal capital is excessively low. Also, with companies under group ownership, it is commonly the case that nominal capital is not as good a yardstick for comparison as net assets.

Questions and answers concerning this comment were conducted in the form of questions from the floor. There is no foreign legal system which uses evaluation by net assets, thus the reply was that nominal capital ratios would do\*<sup>14</sup>. The author countered that nominal capital ratio would function, provided the merger ratio explanation was adequate, but in the absence of such explanation there was undeniably the possibility that nominal capital ratio could be used to carry out a merger without a general meeting decision that would tolerate window-dressed

accounts, and that risk had to be avoided\*<sup>15</sup>. Furthermore, there are five known international methods\*<sup>16</sup> for gauging net assets, which could be used to achieve a merger acceptable to all those concerned.

The author further stated that rather than mimicking the legal systems of various other countries, China should use a system suitable for its current situation, and if that was not the case, there was cause for concern that the system could be used for improper purposes.

#### 4. MINORITY SHAREHOLDERS' PRE-EMPTIVE RIGHT OF SHARE PURCHASE

When a company is made into a wholly-owned subsidiary, the draft decree for amalgamation says that minority shareholders who oppose the merger of the subsidiary should be given the pre-emptive right of share purchase, but the author is of the opinion that there is no need to do so, and is also against the draft decrees which say creditors should be given the right to demand additional collateral or prepayment. The draft decree attempts to apply the same shareholder and creditor protection procedures used in normal mergers to wholly-owned subsidiary conversions, but in the latter case it is applied because shareholders will not directly reduce the value of their stock. Instead, one potential measure which is not included in the draft decree is that the shareholders in subsidiary should be given the right to scrutinize the financial statements of the company which was made the wholly-owned subsidiary. Such a measure could serve as a check that would prevent control of the management of the subsidiary by the parent company

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\*14 Article 413-2 of the Japanese Commercial Code states that new shares issued on the occasion of a merger by a continuing company should not exceed 5% of the total number of issued shares in the continuing company. Furthermore, if the money paid to the shareholders of the company which is eliminated by the merger by the continuing company does not exceed 5% of the net assets of the continuing company, there is no need to obtain a decision of the continuing company's shareholders' general meeting to approve the merger.

\*15 In Japan, if the merger ratio is extremely unreasonable, the directors, auditors and dissenting creditors are allowed to initiate an action as interested parties holding the merger invalid. The Chinese Company Law does not allow lawsuits against the validity of a merger, which makes proper evaluation of the assets even more important for the merger decision.

\*16 The current price method, the liquidation price method, the market price method, the profit return method and the discount cashflow method. In February 1999 the South Korean government proposed its "Big Deal" which aimed for restructuring, diversification and industrial adjustment of the giant financial groups. The Big Deal called for the discount cashflow method to be used to appraise the purchase price of companies.

from diminishing the value of stocks in the parent company. From the point of view of corporate governance, that method can be expected to yield improvements in efficiency after the merger.

This comment was opposed by two speakers from the floor. Their opposition came from the point of view of a policy proposal which says small shareholders should be given protection and a preemptive right of share purchase. However, at a reception the author explained his interpretation that the purchase claim for small shareholders, which is necessary in normal mergers, is not necessary in the case of fully-owned subsidiaries, and this view was greeted with assent. In the case of acquisition, the acquisition is accounted as an investment in the assets section of the acquired company. If the purchase claim on nominal capital is allowed concerning movements in the investment asset, creditors (financiers, corporate bond holders) who belong to the liabilities side would have to be given a repayment claim for the sake of balance. If the creditors are accorded the right to claim a fixed amount from the value of the company, and that right has precedence over the shareholders' right to claim a dividend, the shareholders have the ability to determine for themselves the amount of the company's value which is allowed to outflow in the form of dividends.

Refusal to meet the stock purchase claim avoids expenditure of purchase funds, and allows even companies which lack cashflow to become purchasers. The advantage would be that the number of companies able to become purchasers would increase, accelerating company reform through purchase.

## 5. MERGER AGREEMENTS

The draft decree of amalgamation says that the balance sheets and inventory of property for companies to be amalgamated or liquidated need not be appended to the agreement. However, the merger price and the grounds for the merger are required. Therefore the merger ratio explanation and the financial statements (balance sheets, income statements and statements of cash flows) for the merging and merged companies should be affixed to the merger agreement. Thus the

fact that information disclosure on merging companies to the shareholders of the company making the merger is not required combines with the provision of unnecessary purchase claim rights to shareholders and the lack of opportunity for dissenters to voice their opinions, which increases the likelihood of their exit. Taken together the situation can be regarded, in some cases, as an attempt to force a merger through.

There are also problems with the letter of intent (merger memorandum) for a merger. During the period of deliberation over a merger, cashflow shortfall may necessitate injections of funds from the company planning the merger to the other company. The injections of funds should be regarded as lending. If the memorandum includes the condition that neither the shareholders nor the managers shall declare bankruptcy, it can help to avoid disputes. In China it appears that many cash-strapped state-owned enterprises in the interior are sounding out wealthier state-owned enterprises and collective-owned village companies in coastal areas over the possibility of mergers. Besides earning tax breaks for mergers (the Chinese government provides tax incentives to companies' mergers to encourage amalgamation), companies in coastal zones making mergers gain cheaper workforces and inland sales networks, which make them receptive to merger offers. However, companies receive lump-sum payments in advance for merging, and then declare bankruptcy. It is viewed that the lump sum payment can be treated as nominal capital, thus they do not have to repay the equity investment.

## 6. VESTED INTERESTS BETWEEN EQUITY INVESTORS IN STATE-OWNED ENTERPRISES

Why is it that Chinese state-owned enterprises make no effort to disclose company information? One view holds that the reason is the state sector, which is the equity investor, is not a single unit, thus it does not take steps to maximize share value. This idea could also serve to explain the unreasonable fee collection practiced by local governments (the various fees imposed by local governments, partly by force, on companies), which is a particularly severe problem

for Japanese-affiliated companies.

In most cases the supervisory departments have the right to dispatch managers to companies, but they do not have the right to negotiate on dividends. The supervisory department is usually an agency under the economics department of the district level people's committee, but in most cases the dividend recipient is the Asset Management Bureau of the local provincial level people's committee\*<sup>17</sup>. The department which receives the dividend does not have the authority to allocate the money as part of its own budget for the supervisory department of district level people's committee. Therefore the supervisory department does not instruct the manager it dispatches to a company to increase profits to maximize the dividend. Rather, they use their authority to dispatch managers to enterprises under their umbrella to charge a wide range of fees that help to cover their budget shortages in district level people's committee. That practice can be regarded as unreasonable fee collection. It is a management practice based on recognition of a company's independent management right, and therefore does not contravene the separation of politics from business.

Thus the function of the shareholders ceases to be the maximization of the dividend. Other than the shareholders, interested parties are in the state sector, which is responsible for tax collection. However, the value-added tax is mainly collected by the provincial or district level people's committees, and the profit tax is mainly collected by the central government. Therefore the supervisory departments, which influence the management of state-owned enterprises, direct them to report maximum sales and minimum profits, which leads to widespread window-dressing of accounts, and therefore impedes disclosure of corporate information. If the direction of reform of state-owned enterprises is to pursue corporate governance that emphasizes stock value, rather than corporate governance that emphasizes vested interests, there is a good chance that the problem of unreasonable fee collection could come to an end.

Unreasonable fee collection by the local government is not listed among the expenses which cannot be included in accounts, which is included in the Common Rules for Corporate Finance that were implemented in 1993 by People's Bank of China. Thus they can be accounted under contributions or donation expenditures. Even if the accounting of unreasonable fee collection is disallowed, managers will use their authority over personnel matters to account them as taxable expenses, which would then lead to cashflow shortages. As a means of window-dressing, they could explain the outflow of assets in the same way. According to the Common Rules for Corporate Finance, when investments are made in actual stuff, losses or gains made on re-evaluation must be accounted within the capital reserve, but speculative investment in the coastal zones is made in cash, which does not yield gains or losses on evaluation. Failed speculations become losses which prevent outflows due to the payment of profit taxes and dividends. If the speculation is successful, the actual profits are retained in the coastal zones and in Hong Kong, avoiding the need for accounting, which changes the acquisition cost of investment.

The Chinese Company Act only regulates accounting standards through ordinances with no consideration for conformity with international accounting standards. On the other hand, it states that the financial statements of both limited liability companies and companies limited by shares must include balance sheets, income statements, fluctuation tables on financial position, explanations on financial status, profit distribution proposals and their attached portfolio. Limited liability companies must appoint auditors or audit boards, and company limited by shares must appoint audit boards. An audit board must include one employee representative. However, audits by certified accountants are not required. The regulations say that auditors must perform finance audits, but there is nothing to say that they should audit the accounts at the same time. The Common Rules for Corporate Finance and the standard rules

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\*17 This kind of thing does not happen in Vietnam, which is another socialist country. State-owned enterprises were re-registered in 1995, which enabled unified control by the supervising department. Another reason is that there are no state-owned enterprises managed at the level of provincial people's committees.

of corporate accounting are stipulated. There is room for concern over how effective finance audits will be when conducted by non-specialist auditors. It is stipulated that the business audit should supervise legality, but the Company Law does not specify the written form of the judicious opinion on the finance audit. The only stipulation is that a legally supervised report of financial accounts must be forwarded to shareholders, scrutinized and published.

The way forward for the reform of state-owned enterprises appears to be to work conscientiously for the disclosure of corporate information and the maximization of shareholder profits, and to eliminate the influence exerted on management through powers of personnel appointment. In 1999 each state-owned commercial bank has established a 100% subsidiary of asset management company (AMC). Each AMC has received non-performance loans with face value from its parent bank.

The overdebted state-owned enterprises, the borrowers of such non-performance loans, are motivated to window-dressing accounts, for the lack of integration between supervising department, provincial level people's committee and central government.

A possible foreign investor for such overdebted state-owned enterprises introduced by AMC may not access precise shareholders' value of targeting company, as the targeting company has not been motivated to maximize its dividend profit.

On the contrary, Mr. Jin Jiang Min proposes the idea that government-owned operating companies of assets management with equity investment from private companies should become institutional investors, which invest in state-owned enterprises, and apply checks to them to maximize their dividend profit<sup>\*18</sup>. This is an excellent idea that does not interfere with the system of socialist state ownership.

## CHAPTER VII OBJECTIVES OF ACCOUNTING AND MODELS OF INTERESTED PARTIES

### 1. WHAT IS INFORMATION DISCLOSURE FOR?

The purpose of accounting has two aspects: To be of use in advance in investors' decision-making processes and to be of use in retrospect, gauging the company's performance and the dividend which can be paid<sup>\*19</sup>. Service in advance serves those who are considering becoming shareholders, rather than those who are shareholders already. The fact that companies need accounting information cannot be explained by the shareholder model alone in the context of corporate governance. Retrospective measurement is necessary to help existing investors to decide whether to maintain their investment or whether to sell their stock and recoup their investment. Therefore the shareholder model can explain the purpose of accounting for retrospective measurement. However, besides serving existing investors, retrospective measurement helps interested parties such as those listed below to make informed judgements on their interests.

- Company managers gain information on which to base judgements on how to maintain and expand their business and how to maintain their managerial authority.
- Workers can maintain and improve their level of employment and standard of living.
- Trading partners can decide whether or not to continue doing business with the company, based on fulfillment of the terms of contracts, such as restrictions on the dividends of company bonds and financial restrictions on finance contracts.
- The state can identify taxation targets and ensure observance of the law.

\*18 Jin Jiang Min, "Corporate Governance of Chinese Companies", "FRI Research Report", Fujitsu Research Institute, November 1999.

\*19 "Accounting Workshops", "Finance Research", March 1999 edition, p28.

- The public (civil society sector), in the form of communities, have interests in environmental conservation and community stimulation and, in the form of consumer groups, in the potential for payouts from PL lawsuits.

Thus retrospective measurement can be explained by the interested parties model as well as by the shareholder model.

For investors, the prediction of future cashflow is very important, thus they expect a high level of information disclosure from companies. For trading partners and the civil society sector it is very important to predict the possibility of reduced profits, which necessitates disclosure of disadvantageous information. Companies would like to give maximum disclosure of good news and minimum disclosure of bad news, but even if that approach is proper for prior service, it is improper in retrospective measurement.

The fact that companies employ different standards for information disclosure and accounting in their business activities can be explained by the different sets of interested parties concerned with retrospective measurement and prior service. In the case of continuous business activity, information disclosure and accounting according to the Company Law is required. In the case of rehabilitation-type company insolvency, they should be in line with the Corporate Reorganization Law. In the case of liquidation-type company insolvency, they should be in line with the Insolvency Act. When a company is at the stage of being founded, information disclosure and accounting in the business plan differ under the ordinary Company Law, which can be explained by the differing interested parties for each type of information.

## 2. FINANCIAL ACCOUNTING AND ACCOUNTING FOR MANAGEMENT

Accounting can be regarded as serving as an aid to decision-making and as a means of coordinating

interests through the reporting of accounts <sup>\*20</sup>. Accounting consists of both financial accounting and accounting for management. Accounting for management mainly serves as an aid to decision-making processes, while financial accounting is used to coordinate interests through the reporting of accounts. However, accounting for management as an aid to decision-making requires the gathering of information from many departments, not just from the accounts department. Cost planning is needed, which integrates the management engineering elements of marketing, quality control (QC) and value engineering (VE) with management accounting.

Under that kind of corporate environment, it is no longer good enough to make accounts for finance accounting that are open to charges of window dressing, and only show them to the accounts section.

If the finance accounts held by the accounts department are not accurate, the management accounts produced by the accounts department will also be inaccurate. An accounts department that receives inaccurate management accounting information from other departments cannot conduct accurate cost planning, even if it simply combines that information. It is basically impossible to conduct cost planning by combining information, and consequently there is research into cost planning. The manipulation of the finance accounts by various interested parties risks producing erroneous management accounting, which can cause managers to make mistaken decisions. Legal prohibition is not the reason why window-dressed accounts must not be made. A more important reason is that managers reduce the accuracy of their decisions and lose opportunities to increase their profits. If window-dressing financial statements are loosely regulated, investors may not utilize financial statements for prediction of future cashflow, but utilize financing statement of collateral registration. As collateral law reform which is described after in Chapter IX, may permit that unspecified future accounts receivables of companies are collateralized under registration with

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<sup>\*20</sup> Takashi Nagami, "The Course of Japan's Cost Planning Research", "Reform in Accounting Information", Chuo Keizaiisha, 1999.



notice of financing statement. I can say this stage may be named “from financial statements to financing statement”.

Administrative engineering methods, such as cost planning calculations and QC work, are an area of particular expertise for Japan and Japanese-affiliated companies, and there is no shortage of case study examples in Asian countries, where numerous Japanese-affiliated companies are making inroads. The Southeast Asian financial groups, which pursue the Asian “family business” management style, are known for inadequate disclosure of financial information, while the management of Chinese and Vietnamese state-owned enterprises commonly leave much to be desired in the accuracy of their accounts. Japan should be able to provide them with more effective advice and intellectual support than Western companies and governments can. The technical support provided by the Japanese government is said to be slanted more towards applied assistance than basic theoretical assistance. In some cases guidance in how to pursue quality control can serve as managerial guidance. Real managerial guidance must be management decision support, which combines management and finance accounting. Japanese and Japanese-affiliated companies can serve as models for that approach.

## **CHAPTER VIII REFORM OF INTELLECTUAL PROPERTY RIGHTS LAW**

### **1. WTO AGREEMENT AND EACH COUNTRY’S LEVEL OF TECHNOLOGY**

In the intellectual property field, the move to incorporate the WTO TRIPs (Trade-Related Intellectual Property) Agreement into domestic legislation is becoming a problem. Thailand and Indonesia are behind schedule in making moves towards incorporation of the agreement into domestic law before the end of 1999, while Malaysia and Singapore are making progress.

One reason why Thailand and Indonesia are

falling behind is that they feel the reinforcement of patent rights leads to the monopolization of technology by developed countries, impeding the development of domestic industry. They say that once the material patents demanded by the agreement are recognized, all progress in their agricultural and pharmaceutical industries will stop. They have until 2004 to bring the agreement into domestic law, but they may have problems with the ability of domestic companies to acquire intellectual property rights. The governments of both countries appear to be forgetting to consider the participation of foreign-affiliated companies in their domestic companies.

If the duration of patent protection is long, the amount of royalties to be paid to foreign companies increases, and there is likely to be opposition to limitations on the enforcement of patents. Under the agreement, the use of patents by others through compulsory enforcement is usually placed under the restrictions that the goods concerned should mainly be for supply to domestic markets, and that the patent may only be used by compulsory enforcement when it has proved impossible to obtain consent for the use from the patent holder under commercial terms within a reasonable time frame. Governments are making efforts to strengthen copyright protection in their countries, and if companies in those countries are able to build up their technical expertise and take patents, the royalties on the patents will pass to the patent-holding companies. The governments and local capital in Thailand and Indonesia should learn that if a foreign-affiliated company independently takes a patent with no relation to the foreign parent company, and the patent is licensed locally in the home country, the royalty income from the patent will flow only to the local affiliate company concerned, and will not be siphoned off by the overseas parent company. They expect foreign-affiliated companies to provide corporation tax or high dividends, and they are upset if the company spends large amounts on research and development costs instead. They take the view that it would be better for such companies to obtain technology and patents more cheaply from their parent companies. They could also think of obtaining advanced intellectual property through compulsory enforcement, and using it to manufacture goods for

export that would be more highly competitive in international markets, but that approach would not enhance the level of their technology or skills. Those governments also expect to receive aid-based technological transfer. The Intellectual Property and International Trade Courthouse established in Bangkok in 1998 as one element of Thailand's legal reform is inundated with trademark disputes. It is kept busy dealing with counterfeiting cases rather than global technological innovation and competition. On the other hand, it appears that little progress has been made in restricting the trade in pirated computer software, which is sold in Bangkok.

## **2. THAILAND'S TRADE SECRET DRAFT LAW**

Thailand's Trade Secret Draft Law, to be promulgated within 2000, is a very interesting development. The trade secrets which will be protected are the technological know-how and client ledgers, which are intellectual property not protected under industrial property rights or copyright. Treble damages (punitive compensation) is permitted in cases of contravention, as well as injunctive claims before disclosure occurs. In court cases involving stolen client ledgers, the trade secrets themselves end up being disclosed in the course of the case, thus there is also a conciliation and compromise system to avoid lawsuits. The Law contains many effective measures, but the range of behaviour which does not contravene the Law is too wide. Legally permissible activities include the following:

- (i) Reverse reengineering.
- (ii) Disclosure by government agencies in the name of the public good.
- (iii) Trade secrets uncovered by unique methods and specialist techniques.
- (iv) Trade secrets gained through licensing from another party who did not know the secrets were obtained improperly.

Under (iv), for example, if the trade secret is

obtained through a third party who is unaware of the improper action, it would not be illegal even if the party obtaining the information knew of the impropriety. For example, suppose A obtained trade secrets from B by improper means. Then, suppose C was unaware that the trade secrets had been obtained improperly by A. If D obtained the secrets from A it would be illegal, but if D obtained them from C, the law under (iv) could be interpreted as making the acquisition legal. Furthermore, under (iii) it could be legal to hack into another party's computer to obtain their secrets.

Malaysia and Singapore, which are trying to build up their computer software development and semiconductor manufacturing industries, have completed revisions to their Copyright Protection Laws to cover software protection. There does not appear to be a very high incidence of software piracy in those countries. Malaysia has gone as far as preparing a Cyber Law, and it is pressing ahead with the creation of Multimedia Super Corridor Program. Malaysia is able to introduce such industrial policies because it is confident of the level of its technology and the skills of its people. Under the TRIPs agreement, US opposition made it impossible to unify patent regulations around the first file system, but the Philippines has completed a legal reform to change its system from a first invention system copied from the US system into a first file system <sup>\*21</sup>.

## **3. MALAYSIA'S INDUSTRIAL DESIGN ACT AND FRANCHISE DRAFT LAW**

Malaysia's legislation of its Industrial Design Act and Franchise Draft Law is coming under close attention. The Industrial Design Act was promulgated in 1997, but it was delayed by the Asian Currency Crisis of that year and did not come into effect until September 1999. The Franchise Draft Law is close to being placed before Diet deliberations, and is likely to be promulgated within 2000. It is important to note that laws in Malaysia can wait for a long time after

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\*21 At present the US is the only country which does not use the first file system for patents.

promulgation before they actually come into effect. That is based on the approach of establishing a large number of cases of application of the content of the law, and only putting it into effect finally if no problems emerge. That does not mean that private companies can overlook the content of the law because of its non-promulgation and non-execution.

In Malaysia, Copyright Protection Law is employed to nurture the software industry, while the industrial design protection aims to open up foreign markets for the components industry, and the Franchise Law aims to register franchises in order to regulate foreign franchises operating in the domestic market. Protection of designs will be more useful to the domestic components industry than protection of patents. For the components industry the protection of technology refers to the functions and designs of components, rather than their trademarks. Consumers are willing to pay more for a component of identical design and performance if it carries a better trademark. However, assemblers will choose the cheapest product with a given design and function, regardless of its trademark. The design and function are protected by design rights. In the past the investigation of whether a design was protected by a design right was not conducted in Malaysia. Instead, the policy was that if the right was recognized in Britain it was also recognized in Malaysia. That approach has now been abandoned, and rights are investigated in Malaysia. At the same time, the recognition of partial design rights, which are not recognized in Japan, makes it easier for both foreign-affiliated and local companies in Malaysia to obtain design rights. Japanese and Japanese-affiliated companies in Malaysia should take a much closer interest in acquiring design rights in Malaysia. Therefore the management of intellectual property rights and profit-generating expertise within companies is very important.

#### **4. FRANCHISES AND DEVELOPMENT OF SMALL AND MEDIUM BUSINESSES**

Franchises are a low-cost method for foreign capital to move into the markets of other countries. The foreign company takes a certain proportion of revenue

as a royalty and the local operator acquires the necessary land and buildings. The franchise system is used for the development of fast food chains or convenience store chains, but in the years ahead it could be used increasingly frequently in connection with service businesses, or with manufacturing businesses which incorporate service elements. Franchise contracts incorporate aspects of trademark contracts, technological transfer contracts and raw material supply contracts. Registering all these aspects in one is done to protect the franchisee from being placed under unfair contract conditions. Under Malaysia's preferential policy for Malays, it is likely that most of the franchisees would be Malays, who only possess assets on the small and medium businesses scale.

In Thailand and Indonesia there are no such regulations, and a different approach appears to be taken in those countries. Management rights for the Seven Eleven chain in Thailand are held by the CP Group, which is burdened by enormous debts. If the CP Group's franchise income increases, it will be easier to repay its debts, and its overseas credit rating will improve. On the other hand, most of the franchisees are Thai small and medium businesses or individuals, and the rehabilitation of the Thai economy has yet to trickle down to the country's small and medium businesses. Since the currency crisis it has become possible for 100% foreign capital companies in the retail and service sectors to move into the Thai economy, but due to the business risks involved, foreign involvement for the time being is likely to be limited to joint ventures or technological transfer contracts.

Even the Philippines, which has a tendency to protect its domestic industries, submitted a bill in 1999 that allowed foreign participation in the retail industry, although that was limited to large-scale stores. Since then the Philippine-capital restaurant chain Jolly Bee has achieved great success. Using technology from foreign fast-food chains, they have been able to develop their business to suit the national tendency to favor dining in family groups on foreign dishes. Shoe Mart, the country's leading supermarket chain, succeeded in cutting costs in preparation for foreign capital participation by abandoning the use of price

stickers on goods, but they were sued for breach of the Labeling Law. They aim to save the cost of labeling and the cost of changing labels, but there is doubt as to whether foreign capital will be able to go so far.

This author recommends becoming a franchiser as the best way of moving into the retailing and service sectors of Southeast Asia. However, in Vietnam franchising itself was not permitted by the end of 1999. McDonalds' branches in China are directly managed and not franchises. In China franchises have been impossible for over ten years due to restriction under the Technology Transfer Contract Decree. Both Vietnam and China have decided to allow running royalties of up to 5%, but at that level it would be difficult to introduce world-leading technology and franchises. Considering the fact that the Asian Crisis was a result of excessive equipment investments made in pursuit of economies of scale, it would be better to increase the royalties paid for technology know-how, so that economies of range would function and increase the numbers of technology-oriented company groups.

## 5. SMALL BUSINESS PROMOTION LAW

Legislation to promote small and medium businesses is under consideration in Thailand and China. Thailand's version is intellectual aid, mainly from ex-civil servants of Japan's Ministry of International Trade and Industry. Content under consideration includes the creation of Small and Medium Enterprise Diagnostic System, a stronger Credit Guarantee Association, and support for establishing an enterprise. China's version is very extensive, including tax breaks, credit guarantees and furtherance of the unemployed in order to support the establishment of enterprises, provide them with more guidance and community development. However, this author is of the opinion that what small and medium businesses need is information provision in the forms of databases of potential clients, preparation of management indices, market analysis, and education and training for those starting new businesses, as well as protection for intellectual property, including protection of franchises. These measures would build a competitive

environment which would create independent technology-oriented companies. In Thailand the emphasis is on the development of peripheral (supporting) industries, while in China it is on the development of partners for big companies. However, the important points to not here are that small and medium businesses must not be expected to form subcontractor groups dependent on big companies, and that small and medium businesses should be developed that will be able to make contractual relationships with large companies on an equal footing. Company management for maximizing shareholders' value should be directed towards building companies that are profitable and efficient because they are small. That is a development path that will only be open to them if they can use franchising, technical expertise and intellectual property to avoid dependence on big companies.

## CHAPTER IX REFORM OF COLLATERAL LAW

### 1. THE LACK OF COLLATERAL LAWS IN ASIAN COUNTRIES

The process of claim collection which accompanied the Asian Crisis exposed the lack of local collateral laws. Settlement of mortgage on real estate is the dominant means of setting collateral in Thailand, Indonesia and Malaysia. That tendency combined with the inadequate function of courts to make the process of collateral execution very lengthy. It also became clear that there were many problems involved in making personal guarantees function in practice as a form of collateral. In Thailand when local banks provided finance to local capital companies they accepted the personal guarantee of the president in lieu of real estate. When the company concerned collapses the execution of collateral, based on exclusive right out of bankruptcy asset trust, takes two years. Petitioning the court to seize the company president's individual assets as a means of executing the personal guarantee does not exist as anything more than a trading custom. In the 1999 amendment to the

Insolvency Act the only mention of the problem was an upper house draft proposal that the Act should mention that personal guarantees do not function. This means that it is a business society in which even written pledges of business support do not function.

If information disclosure is inadequate, the basic principle is to provide finance against sufficient collateral, but in Thailand and Indonesia there is a problem with the reliability of collateral which is likely to lead to the provision of finance at higher interest rates instead. Taken to an extreme that could mean that companies could borrow as much as they could possibly afford to service the interest on without going bankrupt. Lending without collateral has to be short-term finance, which means that borrowing centers on the use of short-term finance of one year or less, used on a roll-over basis. As there were no actual bankruptcies among very large companies, competition to provide them with credit even in the absence of adequate disclosure and collateral is intensifying, leading to cases similar to situations which arose in 1995~1997 under Ponzi finance (the situation, so named by Prof. Minsky, where companies reached dangerous positions through speculative lending which they had no hope of repaying and kept re-borrowing to cover their interest payments).

Therefore, is any progress being made in amending the Collateral Law and the Debt Execution Law to make collateral execution easier?

In Thailand the Code of Civil Procedure has been amended so that petitions for debt execution can be made in any court in the country, not just in the court with jurisdiction over the area in which the real estate concerned is situated. It is doubtful whether the amendment has made collateral execution any easier in practice. Mistakes appear to be more likely in setting the counterpart and the property concerned in the title of obligation. It has now become possible to set rights of land lease holding for periods of over 30 years and use those as collateral, but there is no regulation specifying which right has precedence if the lease right was set after a mortgage was placed on the land ownership. As a result, little use is made of the system.

## **2. COLLATERAL LAW IN INDONESIA**

The Real Estate Collateral Law was promulgated in Indonesia in 1996. The key points of the system are that it necessitates the registration of mortgage rights and that a registration fee equal to 0.1% of the finance value is collected when the registration is made. It was expected that collateral execution would be promoted by a change permitting voluntary sale on agreement between the parties concerned, but it appears that the parties concerned do not often reach such agreements. In both Thailand and Indonesia the system is that only the first mortgagee can petition for a mortgage. That is one reason for the custom by which the first mortgagee takes possession of mortgage deed and the original certificate of title for the land, making it practically impossible to dispose of the land. Japanese-affiliated companies in Indonesia hold premises rights because they cannot hold land ownership. These premises rights can also be mortgaged, but as there is no market for premises rights the Japanese-affiliated banks in Indonesia have hardly ever accepted them as collateral. When Japanese-affiliated companies lack collateral to secure offshore finance, the banks should consider becoming the first mortgagee for premises rights. If they also provide finance to the parent companies in Japan, they should have the Japanese company guarantee their position as first mortgagee. This should be done, not because a market for premises rights is forming in Indonesia but because of the promulgation of the Fiduciary Transfer Act in the country on 30th September 1999. The Act has increased the likelihood of buyouts of Japanese-affiliated companies and if the Japanese parent companies do not take collateral while they can, they stand to lose their rights to control their affiliated companies.

## **3. THE ENACTMENT OF INDONESIA'S FIDUCIARY TRANSFER ACT AND US EXPECTATIONS**

The promulgation and execution of Indonesia's Fiduciary Transfer Act was an important element in the amendment of the Collateral Law after the Asian

Crisis. It was the focus of demands by IMF and World Bank for amendments to the Collateral Law. By the analysis of both bodies, the collateral system, which was extremely unbalanced towards real estate security led to excessive lending to the real estate industry, which used short-term foreign-currency borrowing. They were of the opinion that the personal security system should be expanded to encourage greater lending to real businesses \*<sup>22</sup>. However, in Asia it is very easy to change the owner of personal assets and such assets are often concealed when there is the threat of their seizure. That situation led to the introduction of a registration system for personal assets. In Thailand there was the Industrial Machinery Mortgage Law, which is Law on Secured Transactions for Movable Properties, but the country was not enthusiastic over the introduction of a general Personal Security Law. Currently in March 2000 a Commercial Movable Secured Transaction Law is under preparation in Thailand in response to calls from IMF and World Bank. Indonesia's introduction of a personal asset collateral law in the form of Fiduciary Transfer Act had advantages. The primary advantage for the enormously indebted Indonesian financial groups is that prime accounts receivable can be used as collateral, which is an effective way of refinancing their debts. The second advantage is that when a high-rise building is placed on a piece of land and the builder is not the landowner of the holders of premises rights on the land, it was not previously possible to register the building under the Real Estate Mortgage Law. Most of the buildings constructed in Jakarta in the economic bubble period of 1995~1997 are in that position. Land with no facing onto a major road, which was previously almost worthless, suddenly became unprecedentedly valuable and the landowners did not want to sell it. In many cases the land was illegally

occupied by the poor and the building builder/ owners did not want to bear the costs of having them evicted. If the job of evicting the occupants was left to the landowner, and the owner would not receive land rent until after the completion of the building, the builder could have the occupants evicted more cheaply and pay less overall for land acquisition and building construction. In most cases the building was constructed using funds borrowed from banks and the banks signed fiduciary collateral contracts with the building owners under which the bank allowed the owner to hold ownership of the building on completion provided the owner serviced the loan. However, it was possible for the bank to transfer ownership to another party as soon as the original owner missed one loan repayment. With proper collateral registration it is possible to clearly know the transfer situation of a building.

Concerning the first reason, which was the use of prime accounts receivable held by indebted financial groups to refinance their debts, there is a problem over what exactly the targeted prime accounts were. Export credits appear to be the best option. The most convenient would be specified or unspecified export credit accounts receivable to Japanese or US companies. First of all, there is no foreign exchange risk. Japanese-affiliated manufacturers operating as joint ventures between financial groups and Japanese companies hold many such accounts receivable. It has been reported in the press that there are cases where the Japanese equity investor is asked to buy out the portion of the joint venture owned by the local financial group, but that it is more common that overdebted local financial groups requested Japanese partner of the joint venture to buy minority equity portion of the holding company of the overdebted local financial group. It would be better to assume

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\*<sup>22</sup> The amendment of Collateral Law was recorded in the Letter of Intent between IMF and the Indonesian government. The direction and content of the Collateral Law amendment to analyze collateral and introduce personal asset collateral was presented at Collateral Law Reform Seminar for five Asian countries, which took place at the ADB Head Office in Manila on 25th~28th October 1999. The system of registration of personal asset collateral was drawn from Article 9 of the US UCC. The introduction of personal asset collateral in Asia appears to have been prompted by hints in that direction provided by the model form of collateral law presented by EBRD in 1996. In former socialist countries the land is owned by the state, which makes it difficult to accept the transition of land to private ownership through collateral execution, even if the countries concerned have changed to capitalist systems. However, without any collateral, the market economy will not develop. That appears to be why EBRD thought of registering personal assets and introducing a system of personal asset collateral. The common point is that when the real estate collateral system does not function, the personal asset collateral system is used. In 1999, Vietnam, with intellectual assistance from ADB, introduced Collateral Ordinance which includes a system for personal asset collateral.

that they intend to have the accounts receivable used as collateral on a third person's property in the future\*<sup>23</sup>. If that is refused, the accounts receivable and the assets of current Japanese-affiliated companies could be used in future as collateral to sell the Japanese-affiliated companies concerned to US investment companies. It is important to consider that possibility and consider countermeasures. These are known as LBO countermeasures.

At that stage it doesn't matter which of the directors of Japanese-affiliated companies agrees to collateral provision, and it could even be the Indonesian director nominated by the financial group. In Indonesia, if there are no restrictions in the articles of association, each of the directors is individually a representative of the company and it is difficult to cancel the actions of a director once they have been committed. To avoid such a situation the articles of association should include regulations on the board of directors and the managing director. However, even if such regulations have been put in place, if the financial group chooses to pursue such tactics the financial group's shareholders will not accept a change in the articles of association without collateral on a third person's property or buying shares in the subsidiary of a bad financial group. Under Indonesian Company Law, revision of the articles of association requires a resolution passed with a two-thirds vote of all stocks issued at a shareholders' general meeting attended by a two thirds quorum. At a second-round shareholders' general meeting the quorum requirement is unchanged but the decision can be passed by a simple majority of the vote. The law says the collateral registration system will start by 30th September 2000 at the latest. It is not too early to start devising countermeasures.

## **CHAPTER X REFORM OF INSOLVENCY ACT**

### **1. PROBLEMS IN THE APPLICATION OF THE INSOLVENCY ACT**

The operational problems with the insolvency acts in Asian countries can be clearly seen in the refusal of petition in bankruptcy in Indonesia and the handling of foreign creditors under the Chinese GITIC when a bankruptcy is identified, and the subsequent petition under the Insolvency Act. The lessons to be drawn from these problems are that when there is collateral that can be taken it should be taken, even if there is no market for the distribution of such collateral. Thailand, Indonesia and South Korea have made amendments to their insolvency acts since the Asian Crisis, but with the exception of South Korea the results cast doubt on whether or not the rights of ordinary creditors will receive fair protection. As a result, IMF and World Bank have come to emphasize the rights of financial backers who will provide injections of new funding for the rehabilitation-type insolvency procedures, regardless of whether or not that is in line with the insolvency act concerned. They have also come to emphasize the use of executive rights out of bankruptcy asset trusts for collateral in liquidation-type insolvency procedures \*<sup>24</sup>.

### **2. INDONESIA'S BANKRUPTCY ACT AMENDMENT**

Even after amendment, the Indonesian Bankruptcy Act only regulates liquidation-type insolvency

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\*<sup>23</sup> Even if minority shareholder right in subsidiaries of financial groups, other than Japanese-affiliated companies, pass to foreign interests, the financial group can maintain its managerial authority if it retains the controlling share. On the other hand, with their Japanese-affiliated companies the financial groups want to hold a higher position than a minority shareholder in order to maintain big shareholdership which enables to appoint directors. The reason is that it is necessary for relevant Japanese companies to hold equity shares large enough to be able to negotiate with the Japanese companies so that they will present account receivables as collateral for fund management of financial groups' holding companies.

\*<sup>24</sup> The Bankruptcy Law Seminar which took place at ADB Head Office in Manila on 25th~27th October 1999 showed that kind of approach. The World Bank staged seminars of similar content in Frankfurt, Washington and Sydney in 1999. Systems which protect rights to make it easier for new financial backers to come forward are called "Super-lien". That approach, which had been recognized in US legal precedent, was given a legislative basis in 1994, and the same legislation recommendation was made in Hong Kong in 1999.

procedure, thus there has been a case in which an Indonesian court refused to accept petitions of bankruptcy from foreign capital. The court which refused to accept the petition was not an ordinary court but the newly-established Commercial Court, which specializes in bankruptcy and competition law and might have been expected to have the specialist ability to handle the case. The court might have been expected to be able to handle the case through rehabilitation-type insolvency procedure by private arrangement. Under the amendment of Bankruptcy Act, there is a grace period of collateral execution for 270 days, but if no new funds can be obtained in that period, the collateral holder can execute its executive right out of the bankruptcy asset trust, those with rights of recovery can reclaim their own assets from the receiver, and the residue is distributed among the creditors as the company is liquidated. The first rehabilitation-type insolvency process in Indonesia was a government-led private arrangement called the “Jakarta Initiative”. A Japanese bank that has been the largest creditor holds that the debt reschedulings proposed by the Jakarta Initiative were too long and had countered with a proposal for a debt reschedulings of 3~4 years without accommodating requests for reduced interest payments. Against this background one can expect that some financial groups burdened with heavy debts would try to hide some of their assets overseas, and one can infer that they creditors feel that if they agree to debt reduction the portion that has been hidden overseas will not come back.

Some Japanese companies have agreed to private arrangements which switch loan credits to borrower’s equity shares. Under my personal idea on the basis that the legislation of the Collateral Law makes it possible for deposits and other personal assets held overseas to be made subject to fiduciary transfer and registered in Indonesia. One possibility is that negotiations could start for partial debt reduction conditional on collateral setting above refuge assets in overseas. After all, becoming a secured creditor rather than an unsecured creditor will increase the amount that can be recovered and will also give an advantage in checking Indonesian assets, which have been made intentionally complex.

These assets include individual assets, subsidiary assets, holding company assets, and assets held in

other people’s names. Another point that is important to note is the purchase of Indonesian companies by US investment banks anticipating their future buyback by Japanese companies.

### 3. THAILAND’S AMENDMENT OF BANKRUPTCY ACT

Thailand’s amendment of its Bankruptcy Act added rehabilitation-type insolvency to liquidation-type insolvency procedures. The rehabilitation-type procedure removed the previous managers from office, which attracted domestic criticism, but the regulations allowed for the former managers to be appointed as assistant receivers. At the same time, Indonesia and Thailand established specialist bankruptcy courthouses to handle bankruptcy cases.

The revisions of 1999 made the following provisions to assist the progress of rehabilitation plans:

- (i) Equity investors who provided new money while suspecting impending bankruptcy are not deemed to be equity investors, and are placed in the same order of priority as ordinary creditors (thus they have introduced an element of the Super-lien method proposed by the World Bank).
- (ii) The rules for the resolution on the rehabilitation plan were relaxed by dividing it into separate resolutions for each type of creditor, and allowing passage of each resolution on a simple majority vote.
- (iii) The possible denial period was extended from three months to one year.

The first measure makes it easier for the former owner of the company to inject personal assets or borrow from banks to work as a manager in reviving the company. The second measure means that where there are financial institutions which have loaned large amounts but are unsecured creditors, it becomes easier to prepare rehabilitation plans that do not have to match the intentions of those creditors. The third measure cuts the denial period for willful denial from three years to one, combining it with the rule that the ten year denial period cannot be applied even if there was intention of fraud through property alienation at low price. These measures have certainly made rehabilitation easier, but some cases could present problems, such as when assets are transferred for low



prices to receive major debt reductions, and then personal assets which were previously concealed are produced by the former owner to buy back ownership and rehabilitate the company. This author is concerned that the issue of improving managerial responsibility and corporate governance will be neglected <sup>\*25</sup>.

The idea of corporate governance casts doubt on the approach which holds that a lender which provided a loan without collateral when it could have taken collateral is a creditor, and will always have priority over minority shareholders in recovering funds in the event of bankruptcy. Doubts arise because, while it is understandable that major shareholders are interested parties and should wait in line behind creditors, in countries where the rights of minority shareholders do not receive protection, they cannot predict the possibility of insolvency however hard they try. In determining precedence for asset recovery, it is important to consider the degree to which the parties legally lacked access to information. This approach is never used in private arrangements. Looking at China's GITIC insolvency proceedings from that point of view, the importance of leaving scope for negotiation over collateral provision, and of responsibility for assets lost by workers and managers, should be recognized. In many cases small creditors receive 100% refunds, and only larger creditors have to negotiate and reach private arrangements with the major shareholders, but further efforts are required to consider a bankruptcy system that gives more consideration to corporate governance.

#### **4. BANKRUPTCY PROCEEDINGS IN THE PHILIPPINES AND MALAYSIA**

The Bankruptcy Act in the Philippines only handles

liquidation-type procedures, while rehabilitation-type procedures are led by the Securities and Exchange Commission (SEC) with its regulations without any legislative basis by the Congress. In practice, liquidation-type procedures are used by small and medium businesses, while only rehabilitation-type procedures are used for larger companies, as seen in the case of Philippines Airlines, where the rehabilitation was solely a process of arrangement and brokerage. However, banks in the Philippines are run by the major financial groups, in the same way as in Indonesia, but their management policy is to lend prudently not to provide money easily to major companies in their groups. This policy is based on conditions imposed on them by IMF and the World Bank during the debt crisis of the early '80s. In 1999 there was a spate of bank mergers as a means of increasing funds. In Malaysia the Insolvency Act is only applied to individuals, and company bankruptcies are covered by the Company Law.

The receivers are highly skilled civil servants with the ability to use their right of denial to expand the bankruptcy trust. There is little political maneuvering, and they are able to lead many small and medium businesses and even listed companies through liquidation-type proceedings. In 1998 the Renong (Malaysian largest engineering company) Case was permitted to be an exception, because it was too large to be allowed to collapse. It was being rehabilitated with an injection of public funds.

Since 1999 the World Bank has been cooperating with ADB and other international agencies to stage a number of seminars on bankruptcy law. In October 1999 they held a seminar at the ADB Head Office in Manila, which presented the Bank's ideas

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<sup>\*25</sup> On 15th March 2000 the Thai Central Bankruptcy Court accepted the bankruptcy declaration of TPI, the country's largest petrochemical company. Mr. Prachai, Managing Director at that time, who aimed to retain managerial control of TPI, tried that TPI's enormous debts of \$3 billion might be reduced by private arrangement, and he failed his plan by the bankruptcy declaration. Mr. Prachai was able to maintain managerial control on a provisional basis until the rehabilitation planner could be appointed, and the question of whether Mr. Prachai will be able to become an assistant receiver is to be left to the judgement of the rehabilitation planner. Mr. Prachai says the reason he clings to managerial authority is to protect the workers and their families, and preserve communities, but Thai company rehabilitation procedures specify that the former manager must relinquish managerial authority until the completion of the five-year rehabilitation plan. This author is of the opinion that former managers cling to managerial authority out of concern that by the time the rehabilitated company is returned to them five years later it would be empty of managerial resources, as the former assets and workers would have transferred to other companies. Their position is not necessarily at odds with corporate governance.

on the legislation based on the Super-lien concept, which reflects the awareness that little progress is being made with rehabilitation-type procedures in Asia. Rehabilitation requires financiers to come forward who will lend new money to a bankrupt company while fully aware of its bankruptcy. The Super-lien concept protects such financiers in the event of eventual collapse, giving them executive rights from the bankruptcy asset trust in the same way as legally-secured creditors. The basic principle under previous bankruptcy laws was that those who lend money with full knowledge of the company's bankruptcy should be placed on the same footing as shareholders, who are regarded as company insiders. The Super-lien legal reform was enacted in the US in 1994 and the Legal System Council in Hong Kong is reported to have proposed Super-lien legislation. If the idea is adopted around Asia, Japanese banks, which usually lend without collateral and have little financial capacity for providing new money, will be placed in a worse position for the recovery of debts.

## **CHAPTER XI REFORMS OF COMPETITION LAW AND INDUSTRY LAW**

### **1. INDONESIA'S COMPETITION LAW AND CONSUMER PROTECTION ACT**

In 1999 Indonesia enacted an Anti-monopoly and Fair Competition Act (hereinafter Competition Law), Consumer Protection Act and Act for Arbitration and Outside Courthouse Dispute Settlement. It is not clear how fully these acts will be implemented. Implementation of the Labor Law, which was the last legislative act of former President Soeharto, was dropped when the Habibie Administration collapsed. The law was based on comments from ILO that labor unions in Indonesia lack independence. On the other

hand, both the Habibie and Wahid Administrations are keen to ratify the ILO treaty to care for protecting the rights of workers and to get international trustworthiness not to make social damping activities\*<sup>26</sup>.

For Japanese companies, which are used to Japan's consumer-related laws, the enactment of the Consumer Protection Act will work to their advantage in expanding business in Indonesia. The Consumer Protection Act emphasizes the role of administrative agencies in receiving consumer inquiries and providing mediation, as well as the role of the courts that are involved in consumer lawsuits, and the role of Dispute Settlement Agency Outside Courthouse (ADR). The law appears to have been drafted with due consideration for the problems that arise after a foreign company files for petition in bankruptcy. The means of out-of-court dispute settlement stipulated in the Consumer Protection Act are mediation, conciliation and arbitration by permanent consumer dispute settlement agencies in each state. Arbitration does not permit the filing of lawsuits while there is any chance of an arbitrated agreement, which means it includes a demurrer. While the consumers involved agree to arbitration they cannot file a lawsuit, thus the system lacks consumer protection. Therefore the Consumer Protection Act only applies arbitration where there appears to be no prospect of a successful resolution in court. The law clearly states that problems related to the amount of damage compensation and measures to prevent recurrence should be dealt with. It is applied in cases where bringing a lawsuit would not yield a rapid solution and could increase the damage.

The legislation of the Act for Arbitration and Outside Courthouse Dispute Settlement is a general law to augment some of the functional shortcomings of the courts. Permanent dispute settlement agencies were established for the Consumer Protection Act and the Labor Act, and there were also regulations on the acceptance and execution of international trade

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\*26 Compared to the positive attitude to ratification of the ILO taken by Thailand, which enacted Labor Protection Act in 1999, Indonesia appears less keen to ratify. Legal system reforms in various Asian countries have included amendments to labor laws, which are reforms directed towards company restructuring rather than towards strengthening the labor unions' right to organize (the South Korean amendment of 1999, which permits mass-employees dismissal, is a typical example). The focus is on improvement of labor standards and worker welfare.

arbitration. In addition to determining the qualifications for arbitrators and the arbitration procedures, consideration must be given to the regulations which state that no lawsuits may be filed where there is agreement to arbitration in bankruptcy proceedings for individuals or corporations.

The legislation of the Competition Law is very likely to exert a major influence on the business of Japanese and Japanese-affiliated companies. The key points are that if the top three companies combined hold a 75% market share, the situation will be deemed an illegal monopoly, and that Fair Trade Commission has been set up under the jurisdiction of the Minister of International Trade and Industry.

Although the Fair Trade Commission is an independent administrative committee, if it is placed under the authority of Ministry of International Trade and Industry officials who carry out industrial policy, their influence appears to be unavoidable. For example, it could take a harsh view of the business activities of a foreign-affiliated company regarding its market share, based on the policy of developing companies by local capital. One case which can be anticipated is that if a foreign-affiliated company starts an area of business which had not previously existed in Indonesia, it would have a market share of 100% in the newly-established field. If the new business is successful but the Competition Law is applied to it, it could be accused of a market share violation and ordered to split its operations or alienate its business. It is reasonable to assume that the alienated business portion would be transferred to a local capital company in most cases. In the past Indonesia was a high-cost economy due to its oligopolistic market in the absence of Competition Law, and the transition from that state can be expected to take a considerable amount of time. However, in the WTO age there are demands for low tariffs and national treatment, making it difficult to regulate foreign-affiliated companies separately under foreign capital laws. It is important to note that laws such as this, which are in line with international standards, have the scope to function as separate measures for controlling foreign-affiliated companies.

## 2. CHINA'S COMPETITION DRAFT LAW

China has produced a draft competition law as a step towards WTO membership. The text of the draft is an ideal competition law. However, on the subject of exemptions, the person who drafted the bill states "only the basic principles are stipulated here, and regulations for other related problems should be added at the legislation stage in such a way as to guarantee the sound development of domestic industry". It is not clear how that sound development will be guaranteed, but as the exceptions will be left to the administrative legislation stage, there is the problem of how far structural recession cartels, small and medium businesses cartels and special regional exceptions will be permitted. There is also the possibility that the exceptions could work against the better interests of foreign-affiliated companies. In the legislation of Vietnam's Competition Law which may support future Vietnam's WTO membership, the Ministry of Commerce wants to take a position that the law might be an instrument to lead industry policy by its Ministry, which seems opposite policy to WTO principle from the foreigner's eyes. In general, legal reforms which appear from an overseas viewpoint to be making progress, can be seen from inside the country concerned to be moving at a different direction rather than towards the objective. The test of the law can also contain lurking measures which act against the intended functions of the law. These are the sort of points which get overlooked in checks by agencies which are not actually involved in business, and lawyers who are not familiar with local business culture. This is a field in which the legislative reform support offered by Japan has an advantage through cooperation with Japanese-affiliated companies that have been doing business in Asia for long periods. For that reason it is more important to pool experience-based information on failures rather than successes. In many cases the staff responsible for failures are relocated, and their experience goes up in smoke. Legislative reform support should build systems by which information on failures will be highly valued in the marketplace. Rather than arguing about how to apportion blame, it is more important to debate what should be done to yield success next time.

### 3. BANKING LAW AND INSOLVENCY LAWS ON FINANCIAL INSTITUTIONS

As many reports have appeared since the Asian Crisis concerning amendments of banking laws and insolvency laws for financial institutions, this paper will not discuss those matters. The fact that inadequate accumulation of information by banks concerning their major clients is a problem for corporate governance has been made clear when the common problem was manifested in China, Vietnam and Japan, as well as in those countries which were hit directly by the crisis.

The functions that were supposed to disclose corporate information more fully at the time a company receives a loan did not operate well enough. There was a separate problem that the financial institutions may have lacked the ability to appraise the information properly, even if it was made available to them. Even if the appraisal ability was there, the banks' business policies may have led to lending behaviour which downplayed the significance of appraisal findings. The bad asset problems of Japanese banks, which have been widely reported, included the practice of banks lending through associated non-bank institutions as a matter of business policy, even when they were unable to provide finance directly. Similar problems occurred in other Asian countries. The method of using state funds in insolvency proceedings for financial institutions will not be discussed here either, for largely the same reason. The author would like to examine how the differing relationships between banks and companies in various countries influence corporate governance.

In Indonesia, the Philippines and Japan, large-scale business groups operated both companies and banks. In Thailand, South Korea, Malaysia, China, Vietnam and the US, major corporate groups do not operate banking business in the groups. In Indonesia and the Philippines, the banks were smaller than the companies. In other countries the sizes of the banks and companies were balanced.

If companies and banks are in the same group, the group's banks should have had ample information on the companies. It could be described as a more advanced level of corporate information disclosure

applied to specific companies. If the bank is smaller than the company, the level of information disclosure would be lower. The fact that a bad asset problem occurred in Indonesia but not in the Philippines was due to a higher level of discipline in the Philippines, which had experienced a debt crisis at the start of the '80s. In Japan there was a balance of power between banks and companies, with group relationships or main bank relationships in which there were capital relationships between the two sides or personnel of managing director or higher rank were seconded from the bank to the company. The bad asset problem arose despite adequate corporate information disclosure to the bank, partly because of the banks' management policies, and because of the lack of ability of the bank staff seconded to companies (even if they understood financial accounting, they lacked ability in the areas of management accounting and financial accounting rules, or they were not able to fulfill their duties).

Even in an environment in which the market principle of disclosing information to the bank in order to receive finance was operating well, the functions will not serve if it is assumed that the company will never go bankrupt. Finance to state-owned enterprises in China and Vietnam, and finance to financial groups in South Korea appears to have suffered from that problem. China, Vietnam and South Korea need to have loan standards such as the BIS standard which limit the business policies of banks, and there should be compliance with the standards. In addition, the banks need to devise means of ensuring that the personnel they dispatch to join the management of borrower companies function effectively. On the company side, full and conscientious application of corporate insolvency systems and managerial responsibility (pursuit of the duty of explanation and responsibility of directors) would be effective.

Even in an environment in which the market principle of disclosing information to the lending bank on receiving finance is functioning, the analysis of the corporate information disclosed can be overlooked in cases where it is a customary practice to provide finance on the basis of formal collateral guarantees. Finance in Thailand and Malaysia appears to have suffered from that problem. In those countries the bank side needs to be free to set junior collateral rights and

to insist on guaranteed performance. The companies need to generate corporate information with market value, and to disclose that information. The development and thoroughgoing execution of new forms of collateral, such as intellectual property rights and personal asset collateral, stronger functions for the technology trading market and for the auction market for personal assets and real estates, and the disclosure of third-party survey findings would be effective. The third-party surveys would set business and technology indices for the subject country, and compare them to the values for other countries.

These ideas can be applied to stock markets and to the procurement of funds for establishing businesses. China, Vietnam and South Korea need the thoroughgoing use of fire walls and insider rules for their securities companies and investment trusts, practical and effective company insolvency systems and thoroughgoing observance of directors' responsibility. Thailand and Malaysia need systems to expel those found guilty of window-dressing accounts and settlements (including certified accountants who produce such audits) from the market, solid protection for the rights of minority shareholders, competition between superior business plans, and guarantees of the effectiveness of convertible bonds with collateral and convertible finance of stocks with collateral.

#### **4. WTO PRINCIPLE OF NON-DISCRIMINATION BETWEEN DOMESTIC AND FOREIGN BUSINESS**

In Thailand the Alien Business Act has been amended to make it easier for foreign capital to move into the country. The number of fields of business and regions in which foreign capital may not hold a majority of equity has been reduced. Now however, in the WTO age, the Foreign Investment Law and the Domestic Investment Law are to be merged to remove discrimination between domestic and foreign business. Thailand's approach, merging the investment laws while maintaining the Alien Business Act, is somewhat unique. From the point of view of eliminating discrimination, it will be difficult in practice to apply

tax exemptions as a preferential measure exclusively for the benefit of foreign capital. In fact, it is well known that even though the foreign corporate tax exemption is written in the Alien Business Act, the opportunities for applying the exemption are dwindling. Advice from the World Bank suggests that tax breaks should be provided without discrimination to both foreign and domestic investors through methods such as tariff exemptions on the import of capital goods, accelerated depreciation for capital goods, and loss carry over to the next year. The WTO takes a firm stand that reduction or exemption of corporation tax should only be permitted for research and development investment and the development of idle land. The WTO position is unlikely to change, whoever assumes the WTO directorship.

### **AFTERWORD**

The ASEAN Ministerial Meeting which took place in Hanoi in 1998 produced the Hanoi Declaration saying that members would work to bring in foreign capital by allowing 100% foreign capital companies to operate in all fields, in principle, by 2002. This was seen as a way of pulling the region out of the Asian Economic Crisis. On that basis, foreign companies moving into ASEAN countries can no longer demand reduction or exemption of their corporation taxes. The Hanoi Declaration was a diplomatic declaration, and its implementation will vary between countries. Even if corporation tax breaks are obtained, extra costs could be applied in other areas to compensate. If those extra costs are only investment costs such as high land usage costs or personnel costs, they will be easy to account for, but these are now times when investment risks arise. Investment risks could include charges of competition law violations against foreign capital, or the loss of managerial rights through buyouts. Local governments and local companies may be able to manipulate local laws skillfully, but the probabilities are hard to gauge, which makes cost accounting of the investment risks a difficult task. One effective plan would be to use the stronger protection of intellectual property in order to sell technological know-how for

a good price.

Japanese companies are very keen to move into Southeast Asian countries, particularly Thailand. That tendency has resurfaced as the Asian Crisis has passed away. Japanese-affiliated companies play a central role in industrial concentration in Thailand. Industrial concentration involves the gathering of multiple inter-related companies in a confined area, which results in intricate specialization of labor and large-scale gathering of specialisations. Under those conditions there is close sharing of information. This situation has started to emerge in Thailand in parts of the automobile and home electronics industries. However, further examination is needed to see whether the anticipated fruits of industrial concentration, namely deep accumulation of technology, reduced costs of coordination between specialisations, and ease of starting businesses, will actually be realized in practice. The reason for doubt is that while attitudes to technology do not change, there is no prospect of realizing the fruits of industrial concentration. Even if technology is transferred, it does not go beyond skills learned by skilled workers. The problem is whether or not these workers' skills can reach the level of proficiency. Normally those workers who have learned craft skills come to appreciate the interesting nature of the work and accumulate more skills, until they gain the ability to make suggestions about their work. That state is called proficiency. When the suggestions provided by proficient workers benefit the company, that company can generate creative innovation. The evaluation of worker proficiency in Asian developing countries has not been very high in the past <sup>\*27</sup>.

The author believes that creative innovation by companies comprises both technology innovation and managerial innovation, and these two exist in a complementary relationship. The existence of technology innovation can be gauged to some extent once an intellectual property rights law is in place and it becomes clear how far the number of occasions for use and application of the law increases. Managerial innovation is harder to gauge, even when company, bankruptcy and competition laws are in place. That is the case because even without managerial innovation it is possible to generate business profits, as was the case before the Asian Crisis. The legal system reform that is now under way in Asia is building an environment which will stimulate managerial innovation. The fruits of the legal reforms can be used and applied to promote further managerial innovation. Observers are still saying that the old family-based management of Asian companies has not changed, and corporate governance is the same as it ever was. However, legal systems are changing, and the friction caused by maintaining old practices is growing. As Japanese-affiliated companies elsewhere in Asia make managerial reforms in line with the legal reforms, that friction will diminish. In Asian developing countries after legal reform, it needs new types of legal strategy for corporate management. Therefore, although the systems of information sharing are still developing, they have a high chance of success. Whether or not a "growing Asia" is realized in future depends on whether the Asian corporate sector, including Japanese-affiliated companies, can achieve managerial and technology innovation, rather than

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\*27 This idea suggests Japan's unique position regarding legal system assistance to Asia. This author believes that assistance consists of (i) consulting, (ii) coaching, (iii) lecturing and (iv) teaching. (iii) and (iv) give the recipient side new knowledge, while (i) and (ii) help them to discover their existing wisdom. (i) and (iii) are intended to enhance the abilities of the recipients, and (ii) and (iv) aim to lift them to proficiency. (i) and (iii) are unilateral transfers of technology while (ii) and (iv) are bilateral transfers of technology. (i) consists of intellectual assistance according to existing models, delivered by the World Bank, IMF, UNDP and Anglo-Saxonian consulting firms. Their own models are wisdom derived from the application of existing knowledge, and as such it is universally applicable. The approach behind (ii) is to use the techniques of psychotherapy to draw out the recipients' innate problem-solving abilities. In most cases Japan's technical assistance, based on ideas of self-help and delivered in response to requests, falls into the coaching category. (iii) is the most common form for private-sector intellectual assistance towards a wide range of objectives. In many cases it simply talks down to recipients without taking local conditions into account. It often provides recipients with various pieces of information they had already picked up elsewhere. The provision of knowledge under type (iv) is motivated by the desire to understand the recipient side. It is personal and individual and therefore lacks universality. This author is of the opinion that most legal system assistance provided by Japan is of type (iv), because it nurtures, in breadth and depth, the ability to generate innovative ideas based on proficiency.

going back to the way it was before the Asian Currency Crisis.

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