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Lessons from Toshiba: Corporate Governance in the Era of Activist Shareholders

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The most significant, long-running corporate governance scandal in the history of Japan may finally be coming to a head. Following a series of misdeeds and clashes with activist investors over the past seven years, Toshiba Corporation, an icon of the Japanese business establishment, is in negotiations to sell itself to a consortium headed by Japan Industrial Partners, a Japanese private equity fund.

Toshiba's story is a cautionary tale of incomplete corporate governance reforms at a leading Japanese company. It serves as a reminder of the pressures now facing Japanese companies due to dramatic and still ongoing changes in their business and corporate governance environment, including reforms to make Japanese companies more transparent and encourage foreign investment, as well as the rise of investor activism. Even traditional Japanese institutional investors are increasingly willing to support reform proposals that will benefit all shareholders.

Toshiba has been a shocking case for two reasons. First, for decades Toshiba was a pillar of Japan's business establishment, with senior executives regularly serving in key posts in leading business organizations and on important government committees. Second, Toshiba had been proud of its corporate governance. It was an early adopter (among just two percent of listed Japanese companies) of an "American-style" system of executive officers and board committees featuring independent directors when such alternative governance structure became available in 2003.

Toshiba's problems started with a search for new business areas that was typical of Japan's household electronics companies in the early 2000s. They all faced serious difficulties as technological change and the rise of low-cost competitors elsewhere in Asia decimated traditional lines of business, like manufacturing television sets. In 2006 Toshiba decided to "go nuclear" by purchasing Westinghouse Electric Corporation, the largest nuclear power plant company in the US. Bad management and bad luck (including the financial crisis of 2008 and the nuclear power plant disaster in Fukushima in 2011) created significant business and financial problems.

These problems came to light only in 2015 when it was discovered that Toshiba had padded its profits by $1.2 billion (151.8 billion yen) over the prior seven years. The overstatement was systematic: it occurred simultaneously within a number of business units over a long period of time, was known to some members of management, and was largely the result of top management setting unachievable profit goals for business divisions. The president and half the board of directors resigned. To make up for its losses, Toshiba doubled down on its nuclear strategy by purchasing CB&I Stone & Webster Inc., a famous but troubled nuclear power plant builder. Losses related to that poorly planned acquisition bankrupted Westinghouse.

By now insolvent, Toshiba was desperate for new financing to avoid being de-listed from the Tokyo Stock Exchange. It sold a majority stake in the company to some 60 foreign funds, including well-known activist investors. This ushered in years of clashes between Toshiba's traditional management, who wished to preserve Toshiba as a public company, and the activists, who wished to maximize their investment returns by any means, including selling the company to private investors. The ongoing turmoil is evidenced by the company calling five extraordinary general shareholder meetings from 2015 to 2022.

Under investor pressure, Toshiba increased the number and role of independent directors. But the problems kept coming, including another accounting scandal. Finally, early this year it created an independent special committee to solicit proposals from private equity funds regarding strategic alternatives, including selling the company.

The following four lessons regarding corporate governance can be derived from Toshiba's scandal.

1. No company, regardless of its prominence, is immune from corporate governance failures and scandals. Downsizing or eliminating traditional businesses and developing promising new areas of growth are both tremendous challenges that rely on innovation, flexibility, and decisiveness rather than on establishment credentials. In the end, among all of Japan's troubled electronics companies, Toshiba, arguably the most prominent, surprisingly came out the worst.

2. The actual functioning of the board and management is far more consequential than a company's formal corporate governance structure. Toshiba's board may have had a carefully thought out structure, but good corporate governance depends more on people and processes—which were evidently lacking.

3. Leaders of Japanese listed companies can no longer afford to ignore or fail to deal fairly with activist shareholders. Activists can now garner the support of traditional institutional investors (both domestic and foreign) by arguing that they are pursuing the interests of all shareholders. As in the US, even large, prominent companies in Japan are no longer safe from shareholder rebellions if they encounter serious difficulties due to poor investments and management.

4. The age of the conglomerate is over in Japan, as investors demand that companies focus on their core capabilities. This follows a global trend, as General Electric in the US proposed its own plan to split into three separate companies at roughly the same time as Toshiba. There is a new bias against traditional Japanese conglomerates, as foreign — and, increasingly, Japanese — investors prefer to diversify portfolios on their own rather than leave that process to corporate management.

As Japanese businesses continue to internationalize due to their home country's aging population and shrinking market, we can expect more traditional companies to experience similar difficulties in adapting to the rapidly changing business and corporate governance environment. Although at first glance Toshiba's fate may seem an extreme and unlikely one, other Japanese companies should take heed: if current trends continue, the "penalty" for poor management and corporate governance can be far greater than in the past.

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