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Zenichi Shishido

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Abstract

It has long been said that the Japanese corporate governance does not pay sufficient attention to shareholders as the owners of the corporation. And yet, despite this seeming lack of shareholder ownership, Japanese firms have performed quite well until recently. This paper seeks to solve this conundrum by developing the "Company Community" concept as a positive model of the Japanese corporate governance. This model is used to illustrate how the Japanese system of corporate governance solves the hidden problems of the corporate law. These hidden problems of corporate law are common to all developed economies and consist of the dual problems of balancing between monitoring and autonomy of management and balancing between money capital and human capital.

The company community concept solves these problems through an intricate system of monitoring consisting of three levels. The first level is the in-house monitoring by core employees who are quasi-residual claimants and monitor management as a participant in the Community. The second level is the monitoring by cross-shareholders in the firm, the main bank in particular. Cross-shareholding also has the effect of stabilizing the management position against outside control. The third level is the monitoring by exit of the outside shareholders. These multiple levels of monitoring have the effect of stabilizing management yet upholding shareholder ownership as the end game norm.

Japanese Corporate Governance: The Hidden Problems of the Corporate Law and Their Solutions

Zenichi Shishido*

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I. Introduction

A decade ago, T. Boone Pickens, the famous American corporate raider, criticized that shareholders are not given fair treatment as the owners of the corporation in Japan, after he failed in his attempt to gain directors' position in Koito Manufacturing Company,

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one of Toyota Motor's major parts suppliers. Mr. Pickens emerged to be the single largest shareholder after acquiring more than twenty percent of its equity.[1]

The basic legal model of the corporation, whose essence is shareholder ownership, is apparently congruent with the economic concept of efficiency. The question here is why the Japanese corporate practice has been so successful, at least until the end of the 1980's[2], while this practice looks in many respects the opposite of the basic legal model.[3]

This basic question will lead to some sub-questions. What is the legal model of the corporation? Particularly, what does shareholder ownership mean? Why is it efficient? The Japanese corporate governance is much more complicated than the American corporate governance, and is easily misunderstood. We need first to show what it looks like, then we need to consider what it actually is. Finally we have to ask whether and why it could be efficient, given its divergence from the basic legal model.

To solve the enigma of the Japanese corporate governance, I will pay attention to what the corporate law does not say. The corporate law says nothing about how to balance between monitoring and autonomy of management, or about how to balance

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[1] *See* Zenichi Shishido, *A Texan Raid on a Japanese Company*, 151-4 Japan Echo 61 (1989).

[2] Faced with fewer opportunities for reinvestment due to slow growth in the Japanese economy, firms that had previously reinvested profits heavily in expansion significantly decreased this practice in the late 1980's. This led to large levels of free cash flows during this period, which were largely misspent. Even during a period of the bubble age in the 1980s the failure of the Japanese corporate governance was evident in the misuse of free cash flows by management of Japanese corporations. Recessionary forces on the Japanese economy in the late1980's required changes in the corporate governance of the Japanese firm, which were not made. *See* Steven N. Kaplan, *Corporate Governance and Corporate Performance: A Comparison of Germany, Japan, and the U.S.*, KLAUS J. HOPT & EDDY WYMEERSCH ED., COMPARATIVE CORPORATE GOVERNANCE 202 (1997).

[3] It may be suggested that Japanese corporate governance mattered little if at all in the growth of the Japanese economy, but this growth was caused by intrinsic factors in the Japanese and world economy. However, it is argued here that the virtually unparalleled success of Japanese corporations in domestic and international markets is due, at least in part, to the unique design of the Japanese corporate governance system. The strength of the Japanese corporate governance is illustrated by the fact that foreign owned subsidiaries doing business in Japan tend to take on a Japanese style of governance.

between money capital providers and human capital providers. American corporate practice is now struggling to solve these two problems.

The Japanese corporate governance is now in transition because of the drastic change of its background economic market. The typical Japanese model of publicly held corporations had been developed in the economic growth era and reached its heyday in the 1970s and 1980s. In the recession of the 1990s, the Japanese model is being forced to change. In this Article, I will focus on the historical model of 70s and 80s, then refer to the recent phenomena and future expectations.

This paper also attempts to illustrate the dynamics between the corporate governance and its background economic markets, which is a point lacking in the current debate on the convergence in corporate governance.[4] Many theories of convergence in corporate governance have recently been introduced. However, the Japanese corporate governance system evades any simple characterization that these theories attempt. In later sections of this paper I will outline some of the tensions created by the recession between social norms and economic institutions. This is not to say that all social norms will be eliminated. The social norms that run against the background economic market will likely diminish, while those that do not could be useful in accelerating the move toward an efficient governance system.

In Section II, I will show that the Japanese corporate legal system shares the same basics with the American corporate legal system and at the least is not less pro-

[4] *See e.g.,* J. Mark Ramseyer, *Are Corporate Governance Systems Converging?,* Working Paper, Sloan Project on Corporate Governance at Columbia Law School (1998); Lucian Bebchuk and Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance,* Working Paper, Sloan Project on Corporate Governance at Columbia Law School (1998); Curtis Milhaupt, *Property Rights in Firms*, 84 Va. L. Rev. 1145 (1998); Ronald Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, Working Paper (1999); John Coffee Jr., *The Future as History: The Prospects for Global*

shareholder ownership than its American counterpart. In Section III, I will draw the image of the Japanese corporate governance practice by using the key concept "Company Community" and illustrate its relationship to the concept of "employee ownership." In Section IV, I will fill the gap between the legal system and the practice from the perspective of the solutions of the hidden problems of the corporate law. In Section V, I will show that the Japanese corporate governance, not only its legal system but also its practice, share the basics of shareholder ownership as the end game norm, and how the recent phenomena indicate it. Section VI presents some views on the contemporary debate over the convergence of corporate governance systems and future scenarios for Japanese corporate governance. Concluding remarks and a summary of the argument appear in Section VII.

II. Legal Systems

A. The Basic Legal Model of Corporations

In this subsection, I will make clear what are the basics shared by Japanese and American legal systems of the corporation. The basics are, in a phrase, shareholder ownership of the firm; or more precisely, the relationship among assets, money, and people, which is drawn in Figure 1.

The basic legal model of corporations, which is shown as Figure 1 has three points. First, only those who provide money capital as equity holders, having no legal right of reimbursement, have the voting right, usually on a one share-one vote basis, and will be called shareholders. Neither the debt holders, who are other important money

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Convergence in Corporate Governance and its Implications, Working Paper No.144, Center for Law and Economic Studies, Columbia Law School (1999).

capital providers, nor the employees, who are the providers of human capital, are given the voting right.[5]

Second, by a majority vote of stock, the shareholder meeting elects directors, and by a majority vote of the board members, the board of directors elects management. The three-layered pyramidal structure, which consists of shareholders, the board of directors, and management, shows the corporate governance in the narrow sense.[6] The idea is that shareholders as owners (principals) let board members as the agents monitor the management.[7]

Third, shareholders delegate discretionary powers to management via the board of directors. In consequence, management will have the power to order the hierarchy of employees, the power to buy and sell assets, and the power to determine the methods of financing. We can call such discretionary powers the control or the residual right.[8]

In summary, shareholders are the owners of the firm in the sense that shareholders have the control (residual right) by delegating to management and have only the residual claim.[9] Shareholders retain the power to change the management if it does not use the delegated discretionary power for maximizing the shareholders' interest.

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[5] This is the basic model. American law, i.e., state corporation statutes (*e.g.,* 8 Del. Code §§ 151(a), 221), generally does not prohibit debtholders from holding voting rights. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 63 (1991). Typically, however, these are given voting rights through shares, not as an addition to their rights as a debtholder. In practice, it is often observed that debtholders, employees, and management are shareholders at the same time.

[6] Arguments on corporate governance can be divided into two types: corporate governance in the narrow sense and that in the broader sense. The former argues only the principal-agent relationship between shareholders and management. The latter considers stakeholders as the third essential player in the game of corporate governance. *See* John Coffee Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 Geo. L. J. 1495, 1496 (1990).

[7] *See* Bengt Holmstrom, *Moral Hazard and Observability*, 10 Bell J. Econ. 74 (1979).

[8] *See* OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 30 (1995).

[9] *See* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 11, 12 (1996). The residual right and the residual claim could be separated in theory. A non-residual claimant would, however, have little incentive to use the residual rights to maximize the value of the corporation.

Such a basic legal model of the corporation, which is shared by the United States and Japan, is apparently congruent with the economic concept of efficiency. Shareholders are the residual claimants, who have the appropriate incentives to make discretionary decisions.[10] Shareholders also have the least dispersed interests among the stakeholders, which will minimize the cost of collective action.[11] The system that only shareholders have voting rights is efficient because multiple group voters will have dissimilar preferences and cannot obtain a consistent system of choices.[12]

Recently, some scholars argue against such a theory of shareholder ownership, and instead, view the corporation as a coalition of stakeholders.[13] As a positive matter, in any country it is inevitable that stakeholders, such as employees, creditors, and trading partners, influence the direction of corporate management to some degree. Stakeholders monitor management to force the management to keep their "promises" to the stakeholder. The management will try to balance the pressures from multiple stakeholders and as a result, the management will run the business toward the direction in which the compound vectors of monitoring point (*See* Figure 2). The length of each vector, which shows the strength of pressure, depends on the overall bargaining power of the stakeholder. The corporate law makes the vector of shareholders very long by giving them the power of replacing management.[14] Although shareholders seldom use such

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[10] *See* EASTERBROOK & FISCHEL, *supra* note 5, at 68.

[11] *See* HANSMANN, *supra* note 9 at 39, 62, 91, 288.

[12] *See* EASTERBROOK & FISCHEL, *supra* note 5, at 69-70.

[13] *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law, forthcoming*, Virginia Law Review. *See also* MAX B. CLARKSON ED., THE CORPORATION AND ITS STAKEHOLDERS: CLASSIC AND CONTEMPORARY READINGS (1998).

[14] *See* Zenichi Shishido, *Institutional Investors and Corporate Governance in Japan*, in THEODOR BAUMS, ET AL, ED., INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 665, 676 (1994). *See also* John Coffee, *Unstable Coalitions*, *supra* note 6 at 1497, 1501; Masahiko Aoki, *A Model of the Firm as a Stockholder-Employee Cooperative Game,* 70 American Economic Review 600 (1980).

power,[15] shareholders' legal right of replacing management always plays such a significant role that we can call the corporate law system one of shareholder ownership.

B. Differences between the Two Legal Systems of the US and Japan

Although there are several differences between the US and Japan legal systems of corporate governance, they share the same basic structure. In this subsection, I will indicate the differences, which are related to the shareholder-management relationship and shareholder ownership.[16] Then I will show that Japanese corporate law is more loyal to the shareholder ownership than American corporate law.

The background procedural systems are the biggest differences between the US and Japanese legal systems of corporate governance. The United States is a common law country with a flexible procedural system, while Japan is a civil law country with a less flexible procedural system.[17] From the procedural point of view, it is easier for American shareholders to pursue legal remedies than Japanese shareholders, which have to choose one of the actions written in the Commercial Code. American shareholders also enjoy procedural advantages in the areas of pre-trial discovery, and the relatively easy availability of equitable remedies and class actions.

[15] Professors Blair and Stout argue "both in theory and in practice, shareholders' voting rights, at least in publicly-traded corporations, are so weak as to be virtually meaningless. The nominal existence of shareholder voting rights consequently does not pose a serious challenge to the mediating hierarchy model, because in the vast majority of cases shareholders' voting rights give them little or no control over directors, who remain free to balance the interests of, and allocate rewards among, the various group that comprise the firm." *See* Blair & Stout, *supra* note 13, at 72.

[16] For a detailed study of this point, see Zenichi Shishido, *Legal Monitoring Systems in Japan: Legal Possibilities and Current Practice*, in FIONA PATFIELD ed., PERSPECTIVES ON COMPANY LAW: 2 149 (1997). *See also* Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 Harv. Int'l. L. J. 3 (1996).

[17] *See* Zenichi Shishido, *Problems of the Closely Held Corporation: A Comparative Study of the Japanese and American Legal Systems and A Critique of the Japanese Tentative Draft on Close Corporations*, 38 American Journal of Comparative Law 337, 341 (1990).

In Japanese suits involving a corporation, the complaint must be modified to fit into one of the existing categories of suits provided under the Commercial Code. Japanese courts are bound to address only the legal issues raised by the parties themselves, and are thus bound by the plaintiff's request for relief. Courts are unable to balance conflicting interests of the parties except through the procedures of agreed settlement. The American system, on the other hand, is much more flexible as plaintiffs may bring a variety of suits against the corporation and courts may use equitable doctrines to provide relief where the law does not already provide so. Furthermore, US courts may provide relief beyond that requested in the parties' pleadings and may raise motions on their own.[18]

The protection of minority shareholders may also be an important function of the corporate law and may differ among countries. One influential article has asserted that these protections vary across countries due to the origin of the legal system as either common law or civil law.[19] This article makes the claim, using empirical data that

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[18] An example that is exemplary of these differences is the case of a squeeze-out case in a closely held corporation. A squeeze out case occurs when a majority shareholder attempts to siphon off profits in the form of officers' salaries rather than paying dividends in order to force minority shareholders to sell their shares at a distress price. A US court has many options to provide relief to the minority shareholders in such a case. Plaintiff minority shareholders in this case can demand an accounting of the excessive salaries received by the majority shareholders, or they can demand a dividend. A court may find the salaries to be a waste of the corporate assets and order the majority to account for the amount above the level the court finds is reasonable, it could order the corporation to pay a dividend of a specified amount if the court considered the restrictions a violation of the business judgment rule, or it could issue injunctions or distributions of profits if necessary, even if the plaintiffs had not requested this particular form of relief.

Japanese courts have limited authority to provide relief in this case. First, the minority shareholders must first sue on grounds of abuse of discretion based on the resolution at a shareholder meeting to ratify the excessive salary or to not issue a dividend. If the minority shareholders are successful in opposing the squeeze out in the shareholder meeting, the majority must account for the increased salaries because they lose the legal right to retain it. The court in this case has no authority to determine what amount constitutes a reasonable salary. If the minority defeats the resolution not to issue a dividend, they must still wait until the next shareholder meeting at which time a resolution to pay a specific dividend will be decided. Japanese courts have no authority to order an affirmative act such as payment of a dividend. *See* id at 342 and cases therein.

[19] *See* Rafael La Porta, Florencio Lopesz-De-Silanes, Andrei Shleifer, and Robert Vishny, *Legal Determinants of External Finance*, 52 J. Fin. 1131 (1997).

common law systems give more minority shareholder protection and thus have more access to capital due to dispersed corporate ownership. However, the categorization of legal systems as common law or civil law with respect to corporate ownership is too vague to be meaningful.[20] The logical conclusion of this study would suggest that the Japanese system of corporate governance, as a civil law system, provides too few protections to minority shareholders to generate sufficient external capital for its firms.

Shareholders in Japan, however, as in the US, hold many opportunities, beyond the rights to vote their shares, to protect themselves from potential abuse of the management of the corporation. La Porta, et al. define an index of the extent of minority shareholder protections in place across countries based on five shareholder rights that may be embedded in the corporate law.[21] The Japanese corporate legal system meets or exceeds all of these criteria. These include the ability to mail the proxy vote,[22] the lack of a requirement to deposit shares prior to the General Shareholders' Meeting,[23] cumulative voting,[24] existence of a mechanism to relieve oppressed minorities,[25] and a minimum

[20] This important study by La Porta, et al. unfortunately relies on data and data classifications that are inherently unreliable. There are two main reasons for this unreliability. First, the classifications made to generate the data used in the empirical analysis are arbitrary. For example, they use the variable "antidirector rights" to measure shareholders' rights across countries. Underlying this variable are several components measuring whether cumulative voting is allowed and whether an oppressed minority statute is in place. *See supra* note 19 at 1134, 1138. The lack of a link between these legal measures and actual minority protections in publicly held corporations are obvious. As applied to the Japanese case, these data do not reflect a realistic picture of the Japanese corporate law and thus lead to skewed conclusions in the Japanese case.

[21] *See* La Porta, et al., *supra* note 19, at 1134.

[22] *See* Securities Exchange Act, art. 194; The Regulation on Proxy Solicitation; Special Exceptions Law of Commercial Code, art. 21-3.

[23] *See* Commercial Code, art. 224, 224-3, 232.

[24] *See* Commercial Code, art. 256-3

[25] *See* Commercial Code, art. 406-2. The buyout right of the stock with restricted transferability is also used in Japan as a relief measure for oppressed minorities. *See* Commercial Code, art. 204-2.

percentage of share capital required to call an Extraordinary Shareholders' Meeting at or below ten percent.[26]

Beyond these basic measures of shareholder protection, the Japanese corporate law allows for the rights of inspection and proposal. The inspection right allows any shareholder owning more than 3 percent of a corporation's stock to request a court order to review the accounting books and other company documents.[27] The proposal right allows shareholders that have owned more than 1 percent of shares or 300 shares for 6 months to make proposals to be considered at the shareholder meeting.[28] Special voting of a two-thirds majority of stock is a mandatory requirement for fundamental changes in Japan. This means that a one-third minority has the power to veto fundamental changes[29]

Aggrieved shareholders in Japan may also use a derivative action to sue directors of a corporation.[30] Any single shareholder that owns stock for more than six months can file the suit.[31] Contemporaneous ownership is not required in Japan.[32] After the 1994 passage of the Reform of the Commercial Code, a flat fee of about $80 US (¥ 8900) is required to file a derivative action.[33] Formerly, the fee was a proportion of the total damages the plaintiff was seeking. This legal reform substantially increased the number

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[26] The level of ownership required in Japan is only 3 percent. *See* Commercial Code, art. 237.

[27] *See* Commercial Code, art. 293-6.

[28] *See* Commercial Code, art 232-2.

[29] Commercial Code, art 408 III (merger), art 245 I (transfer of business), art 343 (altering the article of incorporation and bylaws), art 405 (dissolution). The Japanese Commercial Code also requires special majority voting on discharging director during her tenure (art 257 II). Actually, it is not easy to evaluate such special majority voting requirements as pro shareholder ownership or not. Although the intent of the Commercial Code is protection of minority shareholders, those special majority voting requirements could work as shark repellants.

[30] For a general discussion of shareholder derivative actions, see Roberta Romano, *The Shareholder Suit: Litigation without Foundation?,* 7 J. Law, Econ, & Org. 55 (1991).

[31] *See* Commercial Code, art 267.

[32] Contemporaneous ownership is the requirement that only those who held shares at the time of a breach of a fiduciary duty may bring a derivative action. For the comparison of shareholder derivative actions, *see* Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 Nw. U. L. Rev. 1436, 1455 (1998).

of shareholder derivative actions in Japan.[34] The Japanese corporation has less authority than a US corporation does to decide whether or not to file a derivative action. In the US, rejection by independent directors of the demand to file suit will be weighed heavily by the court.[35]

With respect to the corporate law itself, the Japanese system, actually, appears more loyal to the basics of shareholder ownership. In particular, the Japanese system upholds the principle of stock majority, more than its American counterpart.[36] In the Japanese system, only shareholders could have voting rights. It is unlawful to give voting rights to non-shareholders.[37] Japanese shareholders have wider voting rights than American shareholders, including rights to determine dividends and executive compensation.[38] Directors cannot be elected neither by preferred shareholders, nor by different classes of common shareholders, but only common shareholders as a whole can elect directors. Non-voting stocks and stock repurchases, which are both often used for stabilizing the management position in the United States, are very restricted in Japan.[39] The only defensive measure which Japanese management can use after a takeover offer is issuing stocks to white squires.[40] There is no anti-takeover statute in Japan. For example,

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[33] *See* Commercial Code, art. 267 IV; Civil Suet Filing Fee Act, art. 4 II.

[34] The number of derivative action cases pending in Japanese district courts was 74 in 1993, 133 in 1994 and 158 in 1995 (statistics from the Supreme Court).

[35] For the Japanese law governing board decisions on derivative actions, *see* Commercial Code, art. 267 II. The US law is summarized in American Law Institute (ALI), Principles of Corporate Governance: Analysis and Recommendations (1994), § 7.04(a)(2).

[36] *See* MITSUHIRO FUKAO, FINANCIAL INTEGRATION, CORPORATE GOVERNANCE, AND THE PERFORMANCE OF MULTINATIONAL COMPANIES 4 (1995).

[37] American Law generally does not prohibit to give debtholders voting rights. *See supra* note 5.

[38] Commercial Code, art 283 I (dividend), art 269 (the amount of compensation of the directors as a whole).

[39] Commercial Code, art 242 I, III (restrictions on non-voting stock); Commercial Code, art 210, art 210-2, art 210-3, art 212-2 (restrictions on stock repurchase). *See* Shishido, *supra* note 16, at 157.

[40] Some poison pills, for example, a corporate bond, which must be paid when more than 5 percent of stock is owned by a shareholder, could theoretically be used in Japan, but have never been used in practice yet and the court response is unpredictable.

an arrangement, which limits voting rights to 10 % even for a shareholder who has more than 10% equity, is not allowed.[41]

From a different point of view, American corporate law is more flexible than Japanese corporate law, even for stabilizing management. If Japanese corporate law were flexible enough to allow shareholders to tailor the legal governance structure to be more hostile takeover proof, then cross shareholding, which is costly, would not be used in practice. It is, however not easy to say which is the better scheme to balance between monitoring and stabilizing management.

The concept of fiduciary duty in Japan is also no less shareholder oriented than its American counterpart. The Japanese Commercial Code contains a statute on the fiduciary duty of directors to the company.[42] The statutory phrase " fiduciary duty to the company" is generally interpreted as "duty to the shareholder" by commentators.[43] Also, no case explicitly allows room for balancing of the interests of stakeholders. Although the American concept of fiduciary duty used to be strict and straight forward, that is the fiduciary duty of directors and officers only to shareholders,[44] recent phenomena in the U.S. have given rise in many states to stakeholder statutes, which allow directors and officers to balance the interests of stakeholders.[45]

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[41] On anti-takeover statutes in the United States, *see* Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cin. L. Rev. 457 (1988); BRUDNEY & BRATTON, BRUDNEY AND CHIRELSTEIN'S CASES AND MATERIALS ON CORPORATE FINANCE 1142 (4th ed. 1993).

[42] Commercial Code, art 254-3. The case law does not distinguish between the duty of care and the duty of loyalty. Arita v. Kojima (Yahata Steel Case), 24-6 Minshu 625 (Sup. Ct., 24 June 1970). Actually, in Japan, there is no American concept of the duty of loyalty, which prohibits agents from obtaining any personal gain. Japanese directors will not be liable as long as the corporation suffers no damage.

[43] See MISAO TATSUTA, KAISHA HO [CORPORATION LAW] 70 (1995). The argument for the social responsibility of companies was clearly denied in scholastic debate in 1960s.

[44] *See* Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 Stetson L. Rev. 23 (1991).

[45] *See* James J. Hanks, Jr., *Playing with Fire: Nonshareholder Constituency Statutes in the 1990s,* 21 Stetson L. Rev. 97 (1991); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 Geo. Wash. L. Rev. 14 (1992); Roberta S. Karmel, *Implications of the Stakeholder Model*, 61

In the United States, the business judgment rule plays an important role to give management certain autonomy. Although Japanese courts are also reluctant to second-guess managerial decisions, the business judgment rule is not established as a legal concept. The distinction between the procedure of the decision and the substantial adequacy of the decision tends to be blurred in Japan.[46]

Another important difference in corporate governance is the board system. Although the basic three-layered pyramidal structure is common to both countries (*see* Figure 1), the Japanese board of directors is not as well separated from management as its American counterpart. The board of directors elects representative directors, who are members of senior management from among board members. Thus, members of senior management must be elected by the board and will sit as board members in Japan.[47] In the United States, although the CEO is a board member for purposes of reporting to the board, members of upper management of US firms are not required to be board members by law. In Japan, the board of directors and the management are not as well separated legally and practically as in the US. The rationale behind the Japanese system is that management should be elected from among directors, who are themselves elected by shareholders. In the US, the board elects management on behalf of shareholders.

Geo. Wash. L. Rev. 1156 (1993); Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty),* 53 Bus. Law. 429 (1998).

[46] *See* Hideki Kanda, *Kabushiki daihyo sosho ni kansuru rironteki sokumen [Some Theoritical Aspects of Shareholder Derivative Suits],* 1038 Jurist 65, 68 (1994). It is an interesting comparison between the comments on the business judgment rule by leading corporate law text books in both countries: "the directors will not be held liable for the consequences of their exercise of business judgment---even for judgment that appear to have been clear mistakes." (ROBERT C. CLARK, CORPORATE LAW 123 (1986)); "the decision must be the one that ordinary business people under the same circumstances would recognise as reasonable and the extraordinarily unreasonable decision should be considered a violation of the duty." (TATSUTA, *supra* note 43, at 90).

[47] *See* Commercial Code, art 261 I.

The statutory auditor is also a system unique to Japan. The statutory auditor is the specialized monitor of illegal acts of directors. Statutory auditors are not members of the board, but they can attend the board meeting and express opinions.[48] One of the most important roles of the statutory auditor is to present an opinion on the annual financial statement to the shareholder meeting in an auditor's report. After 1993, the statutory auditor could take two forms: the board of auditors and the outside auditor for large firms.[49] The statutory auditor may serve a purpose similar to the supervisory board concept utilized in Germany. The statutory auditor does not have decision making power as does the supervisory board. However, the statutory auditor does have access to the debate on business at the Japanese board of directors, whereas the supervisory board does not have access to the debate in the German management board.[50]

III. Japanese Practice with the Company Community

In the previous section, I showed that Japan and the United States basically share the same corporate legal system, and at the least Japanese corporate law cannot be said to be less pro-shareholder than its American counterpart. On the other hand, most observers will agree that Japanese corporate practice is employee-oriented and not pro-shareholder.[51] The object of this section is to draw the image of Japanese corporate practice and explain the mechanism. Although this article is primarily based on the

[48] *See* Commercial Code, art 260-3.

[49] *See* Special Exceptions Law of Commercial Code, art. 18.

[50] *See generally*, Klaus Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 Int'l Rev. L. & Econ. 203 (1994); Thomas Andre, Jr., *Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards*, 70 Tulane L. Rev. 1819 (1996).

[51] *See* Hideki Kanda, *Trends in Japanese Corporate Governance*, KLAUS J. HOPT & EDDY WYMEERSCH ED., COMPARATIVE CORPORATE GOVERNANCE 189 (1997).

economic analysis of law and practice, this section, in particular, focuses on observations of social norms which plays important roles in Japanese corporate governance.[52]

The Japanese corporate governance practice had been developed during the post war reconstruction era and the rapid economic growth era, which reached its heyday in the 1970s and 1980s.[53] We also cannot ignore the continuity from the post war *zaibatsu* companies.[54] Since the bubble crashed in the early 1990's, under the fundamental change of the environment, the Japanese model has been in transition. In this section, I will draw the historical model of the 70s and 80s.

A. *The Company Community as the Key Concept*

Figure 3 is the image of Japanese corporate governance at the positive level. The biggest distinction from the image of the basic legal system (*see* Figure 1) is the location of employees. Employees are located in the center of the corporate governance in Japanese practice, while they are located outside of the corporate governance in the basic legal system. Employees are, at a psychological level, not employed by the company, but belong to the 'Company Community'.[55] The Company Community is the key concept to understanding Japanese corporate governance.[56]

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[52] On the relationship between economic analysis and social norms, *see* Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. Pa. L. Rev. 1643 (1996).

[53] *See* Hideaki Miyajima, *Zaibatsu tsuihou to keieisha no senbatsu: Joutaiizonteki gabanansu sutorakuchua no keisei [Expulsion of Zaibatsu and Choice of Management: Creation of Situation Dependent Governance Structure]*, in JURO HASHIMOTO ed., NIHON KIGYOU SHISUTEMU NO SENGOSHI [POST WAR HISTORY OF JAPANESE CORPORATE SYSTEM] 44 (1996).

[54] The aggregate stockholding system [soyu sei] of the zaibatsu families prevented individual shareholders from intervening in management. Internal promotion from employees to top management was also observed. *See* TAKEO KIKKAWA, NIHON NO KIGYOU SHUDAN: ZAIBATSU TONO RENZOKU TO DANZETSU [JAPANESE COMPANY GROUPS: CONTINUITY AND DISCONTINUITY FROM ZAIBATSU] 29 (1996).

[55] For arguments that pay attention to the community aspect of Japanese companies, *see* JURO HASHIMOTO, NIHON KEIZAIRON: NIJUSEIKI SISUTEMU TO NIHON KEIZAI [A PERSPECTIVE OF JAPANESE ECONOMY: THE TWENTY CENTURY SYSTEM AND JAPANESE ECONOMY] 184 (1991); Ronald Dore, *Equality-*

The Company Community consists of management, board members, and core employees, who share an identity as 'company men'. In Japan, when people say 'company', it means the Company Community. The Company Community provides a *reason de etre* to its members and plays a role as a competing unit in the product market. Members of the Company Community owe, in their psychological level, the duty of loyalty to the Community itself and their fellow members.

It may be arguable how wide is the scope of involvement of employees in the Company Community. The widest interpretation could be all full time employees, including skilled and unskilled laborers are members os the company community. Although this is always the formal interpretation by the management, the actual scope of who is a Community member is smaller. My interpretation is that the widest extent of Company Community membership in practice is to the male white-collar full time employees because they have a possibility, even if it is remote, to be a president or at least a board member. Female workers, even if full time employees, have been considered to be only a temporary workforce and, therefore, ineligible for membership in the Company Community. This characterization is founded upon the fact that the Company Community relies heavily on continuity in distinguishing between insiders and outsiders.

Within the Japanese labor management relationship, it is necessary to distinguish between white-collar workers and blue-collar workers. With white-collar workers, the

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Efficiency Trade-offs: Japanese Perspectives and Choices, in MASAHIKO AOKI & RONALD DORE eds., THE JAPANESE FIRM: THE SOURCE OF COMPETITIVE STRENGTH 379 (1994).

[56] The Company Community is my hypothesis to explain the Japanese practice of corporate governance. To explain how this community is historically formed and stays together is my future project. It looks, however, obvious that the important turning point was the purge of the old management and the election of new management from among the middle manager employees by the occupation army after the War.

Japanese system digests the labor management relationship into the corporate governance system. With blue-collar workers, however, it is still recognized as a labor management relationship and the Japanese system takes a community type approach.[57] All full time blue-collar employees, as with white-collar employees, in Japan have traditionally been given the implicit promise of lifetime employment in order to harmonize the interests of employees with the interests of the firm by essentially locking the employee's future with that of the firm. This breeds a companyism that motivates workers to not only be productive but also fosters the famous 'Japanese management style'[58] wherein managers gather important information and suggestions from blue-collar workers.[59]

The members of the Company Community are given tenure from the beginning,[60] which in Japan is called the lifetime employment system.[61] Generally speaking, every community gives its members tenure, otherwise it is not the community. At the same time, changing communities is basically not allowed. The existence of the Company Community itself has limited development of the external labor market. The premise of

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[57] White collarization of blue collar workers can be historically observed since the pre-war era. *See* Shinji Sugiyama, *Nihonteki koyou kankei no keisei: Shugyo kisoku, chingin, "jugyoin" [Development of Japanese Employment Relashonship: Working Rules, Payment, and "Employee"]* , in NIHON KEIEISHI [JAPANESE MANAGEMENT HISTORY]4 194 (1995).

The relationship of Japanese labor management to blue collar workers has been successfully implanted both in developed countries and developing countries by Japanese companies, along with their direct investments in the world. *See* TETSUO ABO ed., NIHONTEKI KEIEI, SEISAN SISUTEMU TO AMERIKA [JAPANESE MANAGEMENT, MANUFACTURING SYSTEM AND THE UNITED STATES] (1994); HIROSHI ITAGAKI ED., NIHONTEKI KEIEI, SEISAN SISUTEMU TO HIGASHI AJIA [JAPANESE MANAGEMENT, MANUFACTURING SYSTEM AND EAST ASIA] (1997).

[58] This aphorism, commonly known to anyone reading the management literature of the 1980's, refers to the fact that the Japanese labor-management relationship fosters much more interaction between line managers, for example, and line workers. In this system, the knowledge of the line worker is an important component in the production process, as is his skill and manual ability.

[59] The most successful accomplishment of Japanese labor management style is the Toyota Production System, on which numerous studies have been published. *See e.g.,* Fujiwara.

[60] That is, just after their graduation from college. The only existing labor market for white-collar workers has been for new graduates.

[61] Lifetime in this context refers to the retirement age of approximately 55 years of age. Labor law cases have also supported the custom.

the long-term relationship,[62] in that the company will not fire employees and employees will not quit, creates the characteristic practices of Japanese companies, such as the company's investment in training its employees and employee's development of firm specific skills.[63]

Distribution of posts and pay is basically equal among employees with the same seniority for the first fifteen years. This practice is necessary to avoid excessive dissension among the members and keep the community stable.[64] After fifteen years from joining the community, however, successful members and non-successful members are gradually differentiated. This practice forces the members of the community to participate in the long-term competition and gives them the incentive to work hard for a long time. The distribution of aggregate lifetime payments across employees, rather than evidencing strong competition for promotion, is surprisingly egalitarian compared to the United States.[65]

Another distinction of practice from the legal system is that the concept of shareholder is not unified. Shareholders of a Japanese company can be divided into two categories: the inside shareholders and the outside shareholders. The inside shareholders

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[62] Valuing the long-term relationship is a distinctive social norm in Japan. It is observed not only between the company and its employees, but also between the company and its shareholders, and between trading partners.

[63] Professors Ronald Gilson and Mark Roe comment, "lifetime employment (the "bright" side of Japanese labor practices) is tied to the lack of an external labor market (the "dark" side of Japanese labor practices), and this "dark" side may do more of the "work" in encouraging employee productivity and commitment to the firm than lifetime employment." Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, forthcoming in Columbia Law Review. Although they correctly focus on lifetime employment and the lack of an external labor market as one component of the story, these do not represent the whole story. Analysis of the concepts of lifetime employment and the lack of an external labor market ignoring the institutional framework of the Company Community, would not be complete. Lifetime employment is an indispensable factor of the Company Community, and in that sense it plays an important role to give employees incentives to make a commitment to the company.

[64] Such an equal sharing rule to avoid dissension among the members is analogous to employee owned firms. *See eg* HANSMANN, *supra* note 9, at 92.

are the stabilized shareholders who buy and hold the share under the agreement with the management. They are basically cross-shareholding partners, including the main bank. Although the inside shareholders could have voice in the corporate governance in crisis, they usually will not intervene in the decision by the Company Community. A social norm in Japan is that the Company Community should be independent, and that other companies, even if they are major shareholders, should not intervene in the decision making by the Company Community.[66] The outside shareholders include individuals and foreigners whose turnover rate is pretty high. They are not recognized in the corporate governance, but in the financial market. The outside shareholders could have no voice.[67] The only way of monitoring by the outside shareholders is exit.

B. Three Categories of Markets

Japanese markets can be categorized into three types (*See* Figure 3): the free competition markets (square with sequent line); the organized markets (oval); and the incomplete markets (square with dotted line). In other words, the distinction between market and hierarchy is blurred in Japan. The different characteristics of these markets affect the corporate governance.

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[65] Egalitarianism is also a distinctive social norm in Japan.

[66] Professor Mark Roe writes that the Presidents' Council of the keiretsu is an informal mechanism for stockholder influence. It is a plausible speculation because the aggregate voting power of the company presidents attending the President Council constitutes around 20 percent of each company. If the presidents agree, they could decide anything they want. In fact, the Presidents' Council does not play such a decision-making role, but plays the role of keeping the reputation of their Group name, i.e., brand management. *See* MARK ROE, STRONG MANAGERS, WEAK OWNERS 179 (1994).

[67] That is the reason why most of Mr. Pickens' requests were rejected outright by Koito's management. *See supra* note 1 and accompanying text.

Examples of this are the different methods used to divide "managing units."[68] In the US, managing units that were formerly combined in a single firm are often spun-off from the parent corporation in a free competition market solution,[69] while in Japan the same is accomplished using a parent-subsidiary relationship in an organized market solution.[70] The practice in Japan cuts across the distinction between a market and a hierarchical solution while that in the US tends to remain at one of the poles.[71] For example, in Japan a division may be spun off to form a separate company (subsidiary) but the two will remain connected by an equity stake that the former parent firm holds in the spin-off firm.

In Japan, wholly-owned subsidiaries often have the unique use of delegating authority. In the United States, from the governance point of view, there is no distinction between an in-house division and a wholly-owned subsidiary.[72] In Japan, however, wholly-owned subsidiaries are recognized as having more autonomy than in-house divisions. In Japanese companies, headquarter managers often create wholly-owned subsidiaries for the governance purpose of signaling autonomy. Although the precise

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[68] The managing unit is the minimum unit in the company, whose performance is independently evaluated by the monitor, not only on the flow level, but also on the stock level. They are usually recognized as in-house divisions.

[69] Spin-off is the general term used in news papers to refer corporate divisions, that is the separation of a corporation into plural corporations, not only on asset level, but also on shareholder level. The corporate division can legally be categorized into three types: spin-off, split-off, and split-up, depending upon the way of dividing corporation. *See* MELVIN .A. EISENBERG, THE STRUCTURE OF THE CORPORATION (1976). Several statistical studies show that the spin-off has a positive effect on market price of the stock in the US. *See, e.g.,* Gailen Hite and James Owers, *Security Price Reactions around Corporate Spin-off Announcements*, 12 J. Fin. Econ. 409 (1983); Katherine Schipper and Abbie Smith, *Effects of Reconstracting on Shareholder Wealth: The Case of Voluntary Spin-Offs*, 12 J. Fin. Econ. 437 (1983); James Miles and James Rosenfeld, *The Effect of Voluntary Spin-off Announcements on Shareholder Wealth*, 38 J. Fin. 1597 (1983).

[70] The spin- off has almost never been used in Japan partly because it is a taxable transaction and it is ambiguous whether the spin-off is legally effective or not. The biggest reason, however, is that Japanese management could not imagine dividing the Company Community.

[71] *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES (1975).

[72] In the United States, wholly-owned subsidiaries are created either for regulation purpose, for tax purpose, or for limiting liability purpose.

reason for such a business practice needs further study, [73] it is apparent that the practice is based on the social norm of respecting the firm as a legal entity, in other words, humanizing a legal corporation. The same social norm also works in the context of the Company Community for creating "Companyism."[74]

Although the free competition markets are limited in Japan, they play an important role in keeping the Japanese system efficient. The competition in the product market for consumers and that in foreign countries provides the Company Community the incentive to create efficient production systems. The price indication by the capital market with outside shareholders and bondholders also plays an important role as a monitor.[75] Outside shareholders have no voice in Japanese corporate governance, but they could monitor management by exit.[76]

The existence of the organized market is the most recognized characteristic of the Japanese market. This organized market is generally referred to by the term keiretsu, but this term carries with it many interpretations and is thus prone to misunderstanding. For this reason, the preferred use in this paper to use the more accurate terminology given above. There are two different forms of *keiretsu*, vertical and horizontal. Vertical *keiretsu* is essentially a form of vertical integration, examples of which are Toyota and Hitachi. Horizontal *keiretsu*, on the other hand, is simply a cross shareholding group of firms, for example, Mitsubishi and Sumitomo. The typical (mis)understanding of *keiretsu*

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[73] *See* Hideshi Itoh and Zenichi Shishido, *The Firm as a Legal Entity: Its Importance and Implications for Corporate Restructuring in Japan*, working paper (1999)

[74] *See infra* note 105 and accompanying text.

[75] A recent phenomenon in Japan is that rating companies play a very important role as a monitor. *See, Big Decrease of Issuing Common Corporate Bond: Companies are More Selected by Reputation*, Nikkei, September 17, 1998, at 1.

[76] Stock price statistically relates to management turnover. *See* Steven Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the US*, 102 J. Political Economy 510 (1994).

in the U.S. is to consider the horizontal *keiretsu* as having a substantial existence on its own, rather than as a collection of individual firms, each maintaining separate existence and functions.

The organized market does not consist of spot transactions but of long term relational transactions. Most transactions, both of product and finance, between firms are made in the organized market. Transacting firms often hold stocks in each other (cross shareholding) for guaranteeing long term transactions.[77] Therefore, the decision whether they continue or terminate their relationship must be made from the viewpoint of the 'total transaction' which includes the product transaction as well as the equity transaction.[78] Trading partner firms, as inside shareholders, could have some voice in the crisis where the Company Community cannot solve the problem by itself. The main bank is the most influential of these.[79] It is not clear whether the monitoring by the inside shareholder is as a shareholder or as a trading partner.

The external labor market and the corporate control market are very incomplete in Japan. Once you obtain a job in a firm, changing firms will cause you economic loss and your reputation will also be damaged. Therefore, the external labor market has worked very incompletely.[80] The nonexistence of an external labor market has both a positive and negative effect on corporate governance. The lack of the external labor market is the premise of the company community and creates incentives for employees to monitor

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[77] The social norm of valuing the long-term relationship is also observed in the labor-management relationship. *See supra note* 62 and accompanying text.

[78] *See* Paul Sheard, *Interlocking Shareholding and Corporate Governance*, in MASAHIKO AOKI AND RONALD DORE, eds. THE JAPANESE FIRM: THE SOURCE OF COMPETITIVE STRENGTH, 310 (1994).

[79] *See* Masahiko Aoki, Hugh Patrick, and Paul Sheard, *The Japanese Main Bank System: An Introductory Overview*, in MASAHIKO AOKI AND HUGH PATRICK ED., THE JAPANESE MAIN BANK SYSTEM 3 (1994); Stephen N. Kaplan & Bernadette Minton, *Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers,* 36 J. Fin. Econ. 225 (1994).

[80] *See* Gilson & Roe, *supra* note 63.

management due to the 'lock-in' effect. Thus locked in, each employee monitors management to protect his or her stake in the corporation. In addition, the lack of an external labor market has led to the observation that the Japanese labor market leads to a rather dysfunctional competition within the corporate governance structure for promotion and other non-economic benefits.

The corporate control market is almost non-existent. Hostile takeovers have almost never succeeded in Japan because the majority stocks of a publicly traded company are stabilized by cross shareholding measures. The existence of a social norm in Japan that labels hostile takeovers as nearly criminal activity also places limits on the use of this mechanism.[81] Recently, however, some signs of change in the corporate control market have been observed. Weaknesses in some cross-shareholding arrangements have been observed where members of the cross-shareholding group have sold shares to avoid further losses in the capital markets.

C. Monitoring Management

Contrary to the basic legal model of the corporation, in Japanese corporate practice, management is monitored neither by the board of directors as an agent of shareholders nor by hostile takeovers. The monitoring in the Japanese corporate governance consists of three stages. The first stage monitor is the in-house monitoring of

[81] Such social norms are very fragile. The social norm in the US was strongly anti-hostile takeover until the late 1960's or early 1970's when a major investment banker made substantial profits from a hostile takeover. Shortly thereafter the social norm began to recede. For more on the influence of social norms on corporate law systems, *see* Melvin A. Eisenberg, *Corporate Law, Social Norms, and Belief Systems*, Working Paper, (1999) at 60.

the Company Community. The second stage monitor is the inside shareholders.[82] An outside shareholder will has no voice, but can monitor management by exit. In this capacity, the outside shareholders serve as a potential third stage monitor.[83]

Ideally, each member of the Company Community monitors management as a participant in the Community. If the performance of the firm, revealed in the product market and the stock market, is poor, management turnover will take place within the Company Community, without monitoring by shareholders. Ideally such turnover will occur by the voluntary resignation of the responsible management. Pressures from within the Company Community reinforce this voluntary action. As long as such monitoring within the Company Community works well, it is not necessary for shareholders to intervene in the governance of the Company Community. The members of the Company Community have the incentive to maintain good performance of the firm to avoid the intervention by shareholders. In the event that monitoring within the Company Community is ineffective the inside shareholder as the second stage monitor, the main bank in particular, will intervene.

The real practice looks like the idealized situation mentioned above. According to Steven Kaplan's statistical studies, the relationship between management turnover and firm performance in Japan is almost equivalent to that in the United States and

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[82] The Japanese model is not the "interactive" corporate governance model, but the "interdependent" corporate governance model, where the monitoring function is delegated to some stakeholder. Only at the stage of real crisis does the interactive model take place. *See e.g.,* George Triantis & Ronald Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 Cal. L. Rev. 1073, 1106 (1995).

[83] There is some empirical evidence for this monitoring capacity in that the stock prices in Japan are statistically correlate to management turnover. *See* Steven Kaplan, *Top Executive Rewards and Firm Performance, supra* note 76.

Germany.[84] The result of the monitoring is the same but the methods of monitoring have been path dependent so far.

IV. Japanese Solutions to the Hidden Problems of the Corporate Law

In the previous two sections, I detailed the gap between the Japanese corporate legal system and corporate practice. The gap is that while the legal system is based on shareholders' ownership, the practice more closely resembles employees' ownership. In this section, I will present a hypothetical reason for the gap from the perspective of the hidden problems of the corporate law.

The legal system of the corporation, which is based on shareholder ownership, is congruent with the economic concept of efficiency. The corporate law, however, leaves open two important problems. One is how to balance the monitoring and the autonomy of the management. The other is how to balance the human capital and the money capital. Any developed corporate system has its own scheme to solve these two problems.

A. Stabilizing Management by Cross-Shareholding

Although monitoring management is indispensable, too much instability in the management position distorts the incentives of the management. Any reasonable person will hesitate to make relation specific investments if his position is so fragile and also will have no incentive to initiate long-term projects. You need to give some autonomy to

[84] *See* Steven Kaplan, *Top Executive Rewards and Firm Performance, supra* note 76; Steven Kaplan, *Top Executives, Turnover, and Firm Performance in Germany*, 10 J. Law, Econ. and Org. 142 (1994).

the management in order to stimulate their incentives.[85] The point is how to balance between monitoring and autonomy of the management.

Hostile takeovers are viewed as a straight expression of shareholder ownership because, in hostile takeovers, shareholders exactly replace management. Here arises a difficult question. How much should the law allow the incumbent management to defend against hostile takeover attempts? The simple answer logically coming from the basics of shareholder ownership is that the law should not allow any defense at all. It is not the incumbent management but the shareholders that should choose the next management.[86]

Even in the United States, however, most experts do not take such an extreme position, but are forced to take a somewhat balanced position between shareholder ownership and stabilizing management.[87] American courts are agreeable to varieties of poison pills.[88] Most states have anti-takeover statutes.[89] Stakeholder statutes are another phenomenon, which shows state legislatures are becoming more in favor of management stabilization.[90] Now American management is much more insulated from the threat of hostile takeovers than in the 1980s.[91]

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[85] Professors Daines and Klausner show an interesting statistic that most IPO companies have antitakeover provisions even though their shareholders are sophisticated institutional investors, such as venture capitalists. They present the enigma of why such sophisticated shareholders, who are usually controlling shareholders at the IPO, allow the management to choose such charter provisions, which statistically have a negative impact on the stock price. This data are not necessarily enigmatic. From the point of view of this paper, it is quite natural for the sophisticated shareholders to understand the necessity of management stability particularly for the startups that require potentially large relation specific investments from the management. Robert Daines and Michael Klausner, *Value-Maximising Charters: Antitakeover Provisions in IPOs*, N.Y.U. Law School Working Paper (1998), at 17.

[86] *See* Zenichi Shishido, *Corporate Takeovers in Japan*, in JAPAN SECURITIES RESEARCH INSTITUTE, CAPITAL MARKETS AND FINANCIAL SERVICES IN JAPAN: REGULATION AND PRACTICE 129 (1992).

[87] *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 6.02 (1994).

[88] *See* Moran v. Household International Inc., 500 A. 2d 1346 (Del. 1985).

[89] *Supra* note 41.

[90] *Supra* note 45.

[91] Because of the difficulties of hostile takeovers, the proxy fight is now becoming the main battlefield.

The Japanese method of stabilizing management is through cross-shareholding. Between two companies, an implicit agreement is made to hold ownership in the other partners' stock, usually around 1% by nonfinancial firms and up to 5% by banks.[92] Each company makes the same type of implicit agreements with, say, twenty companies. Consequently, they create a spider web of mutual stockholding among inside shareholders, then majority stock ownership of each company is stabilized. [93]

When we compare the cross-shareholding with poison pills and anti-takeover statutes in the United States, an advantage of the cross-shareholding is that it remains in control by the financial market. Keeping cross-shareholding implies costs. If a company's performance is so bad and cross-shareholding partners consider it is not worth holding the company's stock from any point of view, they will sell it off. Now, in fact, we can observe the phenomena that cross-holding shares are often sold in Japan.[94]

As I already mentioned in Section II, the different nature of corporate laws in the two countries may have lead to the different schemes of stabilizing management.[95] American corporate law is basically enabling law. It is flexible enough to allow shareholders (actually, management) to tailor the legal governance structure to be more hostile takeover proof. While Japanese corporate law, which is basically mandatory law,

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[92] While American banks may not hold shares of other companies for investment purposes (Glass-Steagall Act of June 16, 1933, ch. 89, 48 Stat. 162), Japanese banks can own up to 5 % (Securities and Exchange Act art. 65; Anti-Monopoly Law art. 11). This is an important distinction of the legal systems, which contributes to the differences in corporate governance practices. *See* ROE, *supra* note 66, at 95,169. The Anti-Monopoly Law also puts 5 % limits on securities firms and 10% limits on insurance companies (Anti-Monopoly Law art. 11).

[93] *But see* Ramseyer, *supra* note 4, at 546 (skeptical about the effect of cross shareholding as an anti takeover measure). *See also* Hideki Kanda, *Notes on Corporate Governance in Japan*, KLAUS J. HOPT ET AL ED., COMPARATIVE CORPORATE GOVERNANCE: THE STATES OF THE ART AND EMERGING RESEARCH 893 (1998).

[94] The aggregate percentage of publicly traded shares held in cross-shareholding dropped 1.4 to 18.1% for the twelve months prior to the end of 1997. The same overall decrease was observed for the five years from 1992 to 1996. Nikkei, September 22, 1998, at 7.

[95] *See supra* note 41 and accompanying text.

is very loyal to the principle of stock majority, it leaves little room for legal arrangement of stabilizing management. Thus, Japanese corporate governance was forced to find different avenues of protection from hostile takeovers, including that of cross-shareholding.

B. Employees as Quasi Residual Claimants

It is needless to say that you need not only money capital but also human capital to run a business. Actually, no firm could be a winner in world product markets unless it adequately motivates its management and employees. Corporate law, however, says nothing about how to give the human capital providers incentives to make those relation specific investments that contribute the most to the profitability of the firm.

Stock options, management buyouts (MBO)[96], and employee stock ownership plans (ESOP) are American efforts to give managers and employees such incentives.[97] There is another interesting practice in Silicon Valley for balancing human capital and money capital. A usual equity arrangement in Silicon Valley is, for example, that just after creating a corporation among entrepreneurs who invested $0.10 per share of common stock, venture capitalists invest $2.00 per voting preferred stock which is convertible to a common stock.[98]

The Japanese answer to this question is to make employees a quasi-residual claimant, without making them a shareholder. Most Japanese companies pay stable

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[96] *See* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. 119, 133 (1992).

[97] *See* Kevin Murphy, *Executive Compensation*, in ORLEY ASHENFELTER & DAVID CARD, eds., HANDBOOK OF LABOR ECONOMICS, vol. 3B (1999).

[98] *See* MICHAEL J. HALLORAN, ET AL., VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION 5-5, 5-9 (2nd ed. 1995 Supplement).

dividends to their shareholders regardless of the amount of profit[99] and pay their employees bonuses, which reflect the profitability of the company.[100] Also as a member of the Company Community, the social status of the employee will change depending upon the company's success.

The Japanese method of motivating management and employees could be subject to more than such an economic explanation. The feeling of attachment to the Company Community probably provides management and employees the Ethos, or ethical atmosphere, to work hard for the company itself.

Here we can make an interesting analogy to Max Weber's famous study on the relationship between Protestantism and capitalism.[101] Weber points out the paradox that although Protestantism, Calvinism in particular, looks anti-capitalistic, the Protestant Asceticism created the force which was indispensable for the modern capitalism. Weber states, "the psychological sanction of it through the conception on this labor as a calling, as the best, often in the last analysis the only means of attaining certainty of grace."[102] In comparison, although the concept of Company Community in the Japanese model looks anti-shareholders, it created the psychological sanctions which make management and

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[99] The payment of a stable dividend to shareholders, particularly when this dividend does not vary significantly over time, combined with the lack of hostile takeovers, may lead one to the conclusion that Japanese corporate shares are simply preferred shares and therefore investors should be willing to pay only the present value of the dividend stream the share(s) represent. That is also to say that Japanese share prices should not reflect the underlying value of firms. However, it is possible that outside shareholders had an expectation of an 'enlarged pie' in the end. These expectations were thwarted, however, after the crash of the 'bubble' and shareholders failed to realize gains from the enlarged pie. Further, the distribution of new shares to current shareholders with no new investment required, which has been Japanese practice since the early 1970's, may, to some extent, tie share price to profitability by increasing dividends over time in this manner.

[100] An analogy can be made here with workers' cooperatives, where workers receive a relatively small amount of fixed salary at the outset, but will receive the residual later. *See* HANSMANN, *supra* note 9, at 13.

[101] *See, e.g.,* MAX WEBER, THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM [DIE PROTESTANTISCHE ETHIK UND DER "GEIST" DES KAPITALISMUS] (original 1920, Talcott Parson trans., 1930).

employees, including blue-collar workers, work “as if it were an absolute end in itself.”[103] At the very least, their attitude is, in opposition of “continual calculations of how the customary wage may be earned with maximum of comfort and a minimum of exertion.”[104] As a consequence, the Company Community contributed to create one of the most productive business system in the world, including, quite centrally, the benefit for the shareholder.

Employees exercise an element of control through membership in the Company Community. The management will be elected among the employees based on an informal consensus of the employees. In other words, the top of the Company Community doubles as the CEO of the company. This consensus is established not through any formal involvement of the employees in the management selection process but through the long-term process in which employees are continually selected for promotion by the informal consent of fellow employees. This gives informal or implicit voting rights to the employees over which of them will become management. This in a sense gives the employees of a Japanese firm both a quasi-residual claim and a quasi-residual right of control. In that sense, Japanese employees may be (quasi-)owners of firms.

Employees, however, receive no formal elements of control from their status as a quasi-residual claimant. While receiving no formal rights of control, the institution of the company community gives employees substantial informal elements of control. Lifetime tenure of employees and the lack of an external labor market are at least two of the factors forcing shareholders to give a commitment to employees of some implicit control

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[102] Id. at 178.
[103] Id. at 62.
[104] Id. at 61.

rights. These factors combine to limit the substitutability of core employees in the Japanese firm, thus forcing the commitment.

The Company Community is not only similar to employee owned firms, but also solves the problems, which are usually inherent to employee ownership, by being combined with the "Companyism." Increasing the size and social importance of the company is an incentive common to members of the Japanese Company Community ("Companyism").[105] The interesting feature of this is that it decreases the diversity of interests among those controlling the firm, making collective action problems less likely to occur. Surprisingly, this Companyism not only solves the collective action problem, but also solves the horizon problem. It is usually said that employee-owned firms have little incentive to invest in long-term projects because of the employees' lack of transferable residual claims.[106] In Japanese companies, it is not the shareholders but the employees that are eager to invest in long-term projects for the future of the company.

V. Shareholder Ownership as the End Game Norm and Recent Phenomena

A. Employee Ownership?

Many observers of Japanese corporate governance consider that, not the shareholder, but the employee is the owner of a Japanese company at a positive level.[107] But this is not so true as it may seem. The shareholders of Japanese companies just leave the employee as the quasi-residual claimant in order to give them proper incentives.

[105] During the economic growth era, these incentives were shared by shareholders as well. After the recent economic downturn shareholders and members of the Company Community may no longer share such incentives. In such a period shareholders are likely to prefer receiving a dividend over firm growth in size or importance.

[106] *See* HANSMANN, *supra* note 9, at 79.

[107] *See* HIROYUKI ITAMI, JINPONSHUGI KIGYOU [HUMAN CAPITALISM FIRM] (1987).

Often, however, severe conflicting interests between shareholders and employees occur, which may trigger shareholders to use their control to force management to give shareholder interests priority. In the United States, misuse of free cash flows by management may result in a takeover bid, thereby returning the free cash flows to the shareholders in the end game.[108] Waste of free cash flow by management in Japan is not sufficient to trigger the shareholder action in the end game, but negative corporate income and the long run decline of stock price trigger the shareholder ownership end game norm in Japan.[109] The form of the end game in Japan is also different than in the US. In Japan, the end game consists of inside shareholders exercising their voice in the corporation and outside shareholders selling off their shares in a poorly performing corporation. Through these mechanisms, the shareholders in a Japanese corporation force management to give shareholder interests priority and replace the management which does not follow such a norm.[110]

The circumstances required to force such an end game situation may be quite dramatic but occurred in the Japanese economy during the recent and ongoing recession. The importance of the end game norm, which makes the Japanese system efficient, is apparent when compared to the former employee owned firms in East European countries and their struggling in the privatization process.[111]

B. Emergence of the Real Owners in Recession

[108] *See* Michael C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76 Am. Econ. Rev. Papers & Poceedings 323 (1986).

[109] *See* Kaplan, *supra* note 76, at 530, 531; Yukiko Abe, *Chief Executive Turnover and Firm Performance in Japan*, 11 J. Japanese & Int'l Econ. 2, 19 (1997).

[110] The phrase "end game norm" is taken from Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 Univ. Pa. L. Rev. 1765 (1996).

During the economic growth era, most stakeholders of Japanese companies shared the same interest in enlarging the pie, i.e., the scale of the company and its market share. In the economic market where the size of the pie will be larger and larger, it was in shareholders' interest to let employees act as the quasi-residual claimant. Conflicts, of course, always arise when dealing with multiple parties, with differing backgrounds and methods of operation. In this sense, even though most stakeholders were interested in enlarging the pie during the growth era, conflicts were possible in how to do this. The Japanese Company Community motivated the members of the community to set aside their differences and harmonized the interests of members toward the same goal. In essence the Japanese corporate governance system in the growth era may have produced more growth than was otherwise achievable by mitigating the conflicts of interest between stakeholders.

In the recession era, however, many more significant conflicts of interest emerge, for example, how to decrease the workforce and how to use the free cash flow.[112] Such conflicts threaten to put stakeholders' individual interests sharply at odds with one another, because of the nature of this situation as a zero sum game where one group's gains from reorganization offset another's losses. In this situation, shareholders will emerge as the real owner of the company and force management to run the business for the best interest of the shareholder.

Outside shareholders have no voice in Japanese corporate governance, but they could monitor management by exit. Particularly now with financial crisis in Japan we can

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[111] *See generally*, ROMAN FRYDMAN, ET.AL. ED., CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, vol 1&2 (1996).

[112] *See* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization*, 102 Yale Law Journal 871, 881 (1993).

observe the phenomenon that the stock market is emerging to be a monitor of Japanese corporations, blurring the distinction between inside and outside shareholders.[113] The stock market is increasingly giving signals to management that must be followed, in many cases to lay off workers or force management resignations.[114] In this sense, the real owners of Japanese corporations can be said to be the shareholders.

One can wonder why management would ever obey such a signal given by outside shareholders, since they have limited control over the management. The answer to this question lies in the fact that companies must receive financing from both equity and debt markets. This financing becomes critical in a recessionary period. New equity financing through the stock market is difficult or impossible when shareholders are selling off your shares. More importantly, though, is the fact that bank financing to corporations is linked to corporate performance in equity markets. Therefore, outside shareholders can effectively exercise their monitoring power in the corporate governance through their ability to exit by selling off corporate shares.

Management of a corporation with a declining stock price may resign due to the management's perceived fiduciary duty to workers and shareholders. The selection mechanism for managers within the Company Community tends to select management perceiving such a duty and thereby strengthens the perception of the duty within the management. Cross-shareholders may also place pressure on poorly performing managers to resign. These dual pressures tend to push management that is responsible for poor stock performance to resign.

[113] Also, now in Japan, particularly at the stage of crisis of a company, the phenomenon of "interactive" monitoring among banks, trading partners, bond holders, and shareholders can be observed. *See* Triantis & Daniels, *supra* note 82, at 1073.

The outside shareholders are also gaining more voice through shareholder derivative actions. The legal reform of decreasing the filing fee for shareholder derivative actions doubled the number of suits and also changed the mentality of small shareholders in Japan.[115] Now, the shareholder derivative action is the hottest issue in Japanese corporate governance and actually has significant impact on the change of Japanese corporate governance.[116] Japanese management is becoming more careful in making business decisions that are conflicting with shareholder interests. For example, it has become more difficult for the main bank to intervene in rescuing its client company from trouble, if such a rescue contravened the short-term interests of shareholders but may have been in the long term interest of the company or bank.

In this recession, we can also observe the emergence of two incomplete markets: the external labor market and the corporate control market. Once many firms are forced to layoff employees and some big firms have gone bankrupt, people who still keep their jobs consider their position not stable and are loosening their loyalty to the Company Community. Firms are also becoming more positive about picking up people who show their ability at other firms. Because of the recession, firms with poor performance cannot maintain the cross shareholding.[117] There is a possibility that the corporate control market will emerge. The development of these two markets will inevitably affect the future of the Company Community.[118]

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[114] Pressures from the Japanese stock market have already forced some firms to restructure their labor practices. Nikkei, April 23, 1999, at 5. The stock market has also been signaling the substantive adequacy of these restructurings, reflecting success in higher stock prices. Nikkei, March 9, 1999, at 1.

[115] *See supra note* 34 and accompanying text.

[116] *See* Kanda, *supra* note 51, at 189. *See generally*, HIDEYUKI KOBAYASHI AND MITSUO KONDO, EDS., KABUNUSHI DAIHYOSOSHYO TAIKEI [THE STRUCTURE OF SHAREHOLDER DERIVATIVE ACTIONS] (1996).

[117] *See supra* note 94.

[118] For a detailed study of recent phenomena, *see also* Milhaupt, *supra* note 16, at 47.

VI. Convergence Debates and the Future of Japanese Corporate Governance

In the last Section, the effect of the recession in moving shareholders from the back bench to the front bench was considered. The Japanese corporate governance may appear to be changing towards the American way. Will the Japanese corporate governance system simply converge to the American system? That is another question and will be considered in this section.

A. Criteria of Convergence

The dramatic rise of the debate on the convergence of corporate governance is an interesting recent phenomenon.[119] The debate centers on whether world corporate governance systems will ever converge to a single optimal system or whether they will maintain many of the distinct features among them. Roughly speaking, there are three schools of thought on the issue. The first school argues that there is one optimal governance system and that economic institutions will lead world corporate governance systems to converge into the optimal system.[120] The second school predicts that although a single optimal system exists, convergence cannot be expected because of significant transaction costs involved in changing corporate governance institutions, which arise from cultural differences among countries and domestic political frictions.[121] The third school suggests that the search for one 'true' corporate governance system is an endeavor

[119] *See supra* note 4. The topic of the Corporate Law Panel, chaired by Melvin A. Eisenberg, at the 1999 meeting of American Association of Law Schools focused on this issue entirely. Columbia Law School has been a leader in this area with the Sloan Project on Corporate Governance, which in 1997 held a major conference on this topic as well.

[120] *See* J. Mark Ramseyer, *supra* note 4.

[121] *See* Lucian Arye Bebchuk & Mark J. Roe, *supra* note 4.

bound to fail because there is not a single optimal system, but multiple equilibria.[122] Under this view, convergence will not be realized.

There are significant difficulties in engaging in such convergence debates, besides the differences in the conclusions of the three schools. The biggest difficulty is with the criteria adopted by each school for the measure of convergence. The convergence debates primarily utilize three different criteria: dispersed stock ownership versus concentrated stock ownership;[123] capital market centered monitoring versus bank oriented monitoring;[124] and common law regime versus civil law regime.[125] Comparisons of the interrelations among these criteria are used to make inferences on the convergence question. Common law countries generally have stronger protections for minority shareholders, which leads to dispersed ownership.[126] Dispersed ownership is taken as the foundation of the capital market centered monitor; i.e. that hostile takeovers will replace poor management.

These criteria are, however, both ambiguous and insignificant. Japanese corporate governance is a good example that illustrates the shortcomings of the above approach.

Japan obviously is a civil law country, but at the same time has been influenced by American law since the end of the Second World War.[127] Japanese corporate law is, in particular, an interesting mixture of German law, American law, and Japanese idea. The distinction between civil law and common law focuses basically on the procedural

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[122] *See* Ronald J. Gilson, *supra* note 4.

[123] *See* Bebchuk & Roe, *supra* note 4, at 4; Coffee, supra note 4, at 2.

[124] *See* Gilson, *supra* note 4, at 11.

[125] *See* La Porta, et al. *supra* note 19, at 1131; Bebchuk & Roe, *supra* note 4, at 9; Coffee, *supra* note 4, at 6.

[126] *See* Coffee, *supra* note 4, at 6.

system, and does not necessarily lead to different protections of minority shareholders. Japanese corporate law is, as was shown in Section II, no less protective of minority shareholders than American corporate law.[128]

In which way could the Japanese stock ownership structure be categorized: dispersed or concentrated?[129] If one looks at the number of shareholders, and ownership stakes, of Japanese publicly held corporations, the stock ownership appears rather dispersed.[130] Most participants of the convergence debates would, however, categorize Japan as having concentrated ownership because majority stock ownership is stabilized through cross shareholding. If the latter is the correct view, then the real criterion should be how difficult it is for a raider to engage in a hostile takeover, and to be successful in it. If the criterion also evaluates the monitoring voice of shareholders, then today, American institutional investors may have a stronger voice than their Japanese counterpart.

The second criterion, capital market centered monitoring versus bank oriented monitoring, then becomes the most obvious and significant one. This is, however, also not necessarily true. Although the main bank has been playing an important monitoring role in Japanese corporate governance,[131] the capital market has also been an important

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[127] *See, e.g.,* DAN FENNO HENDERSON, FOREIGN ENTERPRISE IN JAPAN: LAWS AND POLICIES 164 (1973).

[128] *See supra* notes 21-35 and accompanying text..

[129] The debate over problems with dispersed versus concentrated ownership and their solutions originated largely with ADOLPH BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). For a discussion of how to control the downside of dispersed shareholder ownership and maximize the benefits from dispersed shareholder ownership and risk bearing, *see* Eugene Fama & Michael Jensen, *Separation of Ownership and Control*, 26 L. Law & Econ. 301 (1983). For a discussion of the political forces driving corporate structure and the structure of shareholding, *see* Mark Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10 (1991).

[130] The top five owners of Japanese corporations own collectively 33% as opposed to 25% in the US and 41.5% in Germany. *See* Stephen Prowse, *Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms among Large Firms in the U.S., U.K., Japan and Germany*, 4 Financial Markets, Institutions and Instruments 1 (1995).

[131] Some observers argue that the role of the main banks has been much too exaggerated. *See* TOSHIRO MIWA, FIRMS AND INDUSTRIAL ORGANIZATION IN JAPAN 120 (1996).

monitor. The management turnover and stock price are statistically correlated.[132] There have always been quasi-hostile takeovers, in which management is forced to agree to being merged. In this current situation of financial crisis, in particular, most observers would hesitate to categorize Japanese corporate governance as having bank oriented monitoring.[133] Japanese banks' monitoring capacity is getting weaker and the weight of the capital market as a monitor is getting heavier. It is true that American corporate governance used to symbolize capital market centered monitoring,[134] but not any more. Because of the development of poison pills and anti-hostile takeover statutes,[135] real hostile takeovers are now very rare.[136] Instead of hostile takeovers, institutional investors[137] and independent directors[138] are currently more significant monitors in the United States.

From the viewpoint of corporate governance, the issues of whether ownership structure is dispersed or concentrated, and whether monitoring is capital market centered or bank oriented are not substantial points. The really important point that must be raised

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[132] *See* Kaplan, *supra* note 76.

[133] A recent editorial in the Japanese newspaper Nikkei claims that the Japanese main bank system no longer works, citing the fact that Nissan's main bank was not consulted by Nissan on the alliance between Nissan and Daimler/Chrysler. Nikkei, May 9, 1999, at 7.

[134] *See* Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965); Michael Jensen, *Takeovers: Their Causes and Consequences*, 2 J. Econ. Perspectives 21 (1988); Richard Roll, *Empirical Evidence on Takeover Activity and Shareholder Wealth*, in John C. Coffee, et al., eds., KNIGHTS, RAIDERS, AND TARGETS, 241-252 (1988).

[135] See Martin Lipton, CORPORATE GOVERNANCE IN THE AGE OF FINANCE CORPORATISM, 136 U. Pa. L. Rev. 1 (1987); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cincinnati L. Rev. 457 (1988).

[136] *See* JESSE CHOPER, JOHN C. COFFEE, AND RONALD GILSON, CASES AND MATERIALS ON CORPORATIONS 895-935 (1995).

[137] *See* John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277 (1991); Bernard Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811-893 (1992); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum. L. Rev. 795-853 (1993).

[138] See Roberta Romano, *Corporate Law and Corporate Governance*, 5 Industrial and Corporate Change 279-297 (1996); Benjamin Hermalin and Michael Weisbach, *Endogenously Chosen Boards of Directors and Their Monitoring of the CEO*, 88 Am. Econ. Rev. 96-188 (1998); Laura Lin, *The*

as the criterion of an efficient corporate governance system is balancing between monitoring and autonomy of management, in other words, the degree of stability of the management position.[139] In this functional sense the corporate governance systems have already converged, at least within the United States, Germany, and Japan.[140]

As a formal convergence theory, it is more useful to argue what are the basics that must be shared by any efficient corporate governance system. These basics are, at the least, shareholder ownership as the end game norm,[141] and a fairly liquid capital market, which quickly reflects the performance of a company. On the latter point, as Professor Coffee predicts, securities regulations and accounting systems will converge.[142] One can also add, as an indispensable basic for efficient corporate governance, the establishment of property rights.[143] Although this point would be considered as the matter of course among the developed countries, we can understand how important it is if we observe the privatization struggle in the Eastern European countries and Russia.[144]

Another difficulty is that most convergence debates lack discussion on the point of the relationship between corporate governance systems and their background economic markets. The optimal system for a growing economy and that for a matured or declining economy may be different. The convergence debates will be useless unless this point is taken into consideration. Japanese corporate governance is a good example,

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Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 Nw. U.L. Rev. 898-976 (1996).

[139] *See supra* notes 85-95 and accompanying text.

[140] *See* Kaplan, *supra* notes 76; Kaplan, *supra* note 84.

[141] *See supra* notes 107-111 and accompanying text.

[142] *See* John C. Coffee, Jr., *supra* note 4, at 116.

[143] See Harold Demsetz, *Toward a Theory of Property Rights*, 57 Am. Econ. Rev. 347-350 (1967); Andrzej Rapaczynski, *The Role of the State and the Market in Establishing Property Rights*, 10 J. Econ. Perspectives 87-103 (1996).

[144] *See* ROMAN FRYDMAN, CHERYL GRAY, AND ANDRZEJ RAPACZYNSKI, EDS., CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA, vols. 1 & 2 (1996).

which was effective for enlarging the economic pie but now no longer looks effective for sharing this pie.

If we hypothesize that the United States and Japan share the same background economic market, would their corporate governance systems formally converged? This question will lead us to the debate on social norms versus economic institutions. One can argue that economic institutions will change social norms.[145] I agree that the social norm, which goes against the economic institutions, cannot survive in the business world. There could be, however, many social norms, which are not necessarily counter to economic institutions. Such a social norm could survive and could play an important role in the corporate governance. Good examples are the "Company Community" and "Companyism" in the Japanese corporate governance. They contributed a lot to the economic growth of Japan, but now in recession, they are loosing their economic rationality and struggling to survive.

B. Destiny of the Company Community

The prediction of the future of Japanese corporate governance is to predict the destiny of the Company Community. The Company Community has obviously been an effective system to give the human capital providers the incentive to work hard, but now its inefficiencies are revealed. Also the premises of its existence are loosing ground, such as the possible disintegration of the lifetime employment system. The tough decision for Japanese companies now is whether they abandon the competitive advantage and take the structure of the American system, or they modify in keeping with the concept.

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[145] *See* Ramseyer, *supra* note 4, at 531.

Whether the Company Community will survive or disappear may depend on how long the current recession will continue. A longer recession will create a situation where shareholders and employees have to share the decreasing pie. In such a situation, shareholders use their control more often than usual and force management to layoff employees; then the lifetime employment, which is the most important premise of the Company Community, will be diminished. The effect of this will be irreversible.

There is a very interesting statistical study on the historical change of worker turnover rate both in the United States and Japan. During the 1920s and the 1930s, the turnover rate in both countries had remained almost equal. In the 1940s, however, the turnover rate in the United States jumped and has stayed at a higher level than that in Japan.[146] The statistics suggest that the Great Depression in the United States, which continued for more than ten years, changed the labor management relationship in the United States.

Corporate governance systems exhibit points of strength and weakness. The Japanese system concentrates all human capital providers' incentives to the single interest of the company.[147] There are, in particular, three important problems in Japanese Corporate Governance, which will force the change of the system. Two of these problems center on the monitoring of management. The third centers on the inefficiencies arising from the equal treatment of employees in terms of wages and promotion, which are exaggerated significantly in a conglomerate corporate structure.

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[146] *See* Chiaki Moriguchi, *The Evolution of Employment Systems in the US and Japan, 1900-1960: A Comparative Historical and Institutional Analysis*, presented at The Changing Japanese Firm conference at Columbia Business School, December, 1998, at 33-38.

[147] *See supra* notes 99-106 and accompanying text.

First, there are few means available to fire bad management when they do not voluntarily resign. In case of poor performance, the management is expected to resign in Japanese corporate practice. The Company Community has few effective methods to get bad managers out. The second stage monitoring by the inside shareholders, while possibly more effective, takes too much time.

Second, there are few monitoring systems for shareholder interests through voice, when their interests conflict with the interest of the Company Community. During the economic growth era, shareholders and employees shared almost the same interest, so shareholders were able to delegate monitoring to the Company Community. In the recession, however, the interest of shareholders and that of employees will conflict, particularly on the use of free cash flow.[148]

Solving these problems will require a monitoring unit that is independent of the Company Community. A possible way to create an independent monitoring unit is the reformation of the board of directors. The board of directors of Japanese companies has never played its monitoring role. Almost all members of the board other than the representative directors, who are senior management, are junior management. The board of directors in Japan is not the monitoring unit, but a part of the managing unit. Actually, the board of directors does not monitor the CEO, but the CEO monitors board members. Having independent directors may contribute to make the board of directors play the role of monitoring, particularly for representing shareholders' interests.[149] Some Japanese

[148] Some observers of the Japanese economy suspect that many Japanese companies may have used free cash flow, which accrued during the 1980s, not for increasing ROE, but for "empire building", i.e., overinvestment. For monitoring such a risk, the debate in the boardroom for the interest of shareholders is indispensable.

[149] *See, e.g.,* April Klein, *Firm Performance and Board Committee Structure*, 41 J. Law & Econ. 275-303 (1998); Romano, *supra* note 138, at 297.

companies have already introduced a few independent directors.[150] Most Japanese companies, however, feel difficulties with outsiders on their board because outside directors are foreign to the Company Community concept.

As noted above, the Company Community may lead to inefficiencies related to problems with conglomerate structure. The first is that the equal treatment required to maintain a company community leads to inefficiencies which are accentuated in the large conglomerate community structure. The second is that the incentive benefits of the company community break down due to accountability problems in the conglomerate structure leading to ambiguous performance of management units. These factors, combined with the fact that there is no monitoring unit independent of the management unit, leads one to suggest that this structure tends to inefficiency.

The structure of holding companies could solve the difficult problem of introducing the independent monitoring unit and decrease the inefficiency of conglomerates while, at the same time, it could maintain the benefits of the Company Community.

First, the company community should be conceptually defined at the same level as the management unit. A management unit is the smallest segment of a corporation maintaining individual, unit-specific, profit and balance sheet reporting structures. The social norm in Japan is to recognize each Company Community as a legal corporation.[151] A holding company is a legal corporation consisting of several managing units, each

[150] Sony is the leader among Japanese firms in reforming the board system in Japan. Sony recently limited the number of board members to 10, with 3 outside directors and 7 inside. Professor Nakatani of Hitotsubashi University was recently nominated to one of the outside director positions. Nikkei, March 30, 1999, at 15.

[151] *See* Ito & Shishido, *supra* note 73.

having the status of a legal corporation.[152] In terms of maximizing the beneficial aspects of the company community, the holding company should be preferred to the conglomerate.

At a fundamental level, the holding company structure respects the social norm that each legal corporation maintain each individual company community.[153] This structure also allows the holding company to escape the inefficiencies of conglomerates. The holding company structure minimizes the inefficiencies of equal treatment within the corporation by allowing disparate treatment across company communities, but still maintaining the norm of equal treatment within. In a holding company, with the company community defined at the level of the management unit, the problem of ambiguous performance disappears because each unit or community reports on and is accountable for its own performance by definition. Finally, holding company structure imposes a monitoring superstructure of its own management on the group of company communities within it. This solves the more general problem in Japanese governance of a lack of a monitoring unit independent of the management unit.

Holding companies have only recently been recognized in Japan as a legitimate corporate structure.[154] Many companies have expressed an interest in pursuing this corporate form.[155] The structure of holding companies suggests that they will be quite successful in Japan in part because they solve the problems of conglomerates. They will also be successful because they are a tangible representation of the idea that while social

[152] Merging several management units into one forms a conglomerate corporation.

[153] *See supra* note 74 and accompanying text.

[154] *See* 1997 Reform of Article 9 of the Anti-Monopoly Law.

[155] Mitsubishi Chemical has begun preparations for a change in their corporate structure to a holding company format. Nikkei, January 22, 1999, at 11. Softbank has announced a similar strategy. Nikkei, February 11, 1999, at 11. Industrial Bank of Japan is following suit as well. Nikkei, April 2, 1999, at 7.

norms that fight economic institutions will generally lose, economic institutions that change by utilizing non-conflicting social norms will improve upon any alternative.

VII. Conclusion

In spite of its outside appearance, the Japanese corporate governance practice has always kept the basics of the legal system of corporations, i.e., shareholder ownership as the end game norm. Otherwise, Japanese corporations would never have been so successful. The two distinct characteristics of the Japanese corporate governance practice: cross-shareholding and "employee ownership", can be explained as the Japanese solutions of the hidden problems of the corporate law: balancing between monitoring and autonomy of management; and balancing between human capital and money capital.

Those are not only Japanese phenomena. Every successful economy keeps the principle of shareholders' ownership and develops its own methods to cope with the two problems. Those methods are very much influenced by the background economic markets. Also we cannot deny the cultural and political influences. In that sense, although details of corporate governance systems are path-dependent, the basics and the functions have already converged.

The change of the background economic market necessarily leads to changes in the Japanese corporate governance model. Once the growth of the Japanese economy has slowed or stopped, the Japanese stakeholder must share in a stable or decreasing pie, leading to conflicts in interests. As a result, independent monitors for the shareholders' interests become necessary. The decline in cross-shareholding is leading to the emergence of the corporate control market. Labor markets for employees are also

emerging. In this new environment, the company community faces increased pressure to change.

No corporate governance system is perfect. There is always complementarity. The Japanese corporate governance system, which is based on the Company Community, has the advantage of concentrating incentives of all human capital providers into the interest of the company, but the disadvantage of slow monitoring and waste from equal treatment. The structure of a holding company is a commendable solution to maintain the advantages of the Company Community and to minimize its disadvantages.

[Graphs not included in this version.]