Title
Changes in Japanese Corporate Law and Governance: Revisiting the Convergence Debate

Permalink
https://escholarship.org/uc/item/9376480h

Author
Shishido, Zenichi

Publication Date
2004-08-25
Changes in Japanese Corporate Law and Governance:

Revisiting the Convergence Debate

Zenichi Shishido

I. Introduction

Since the last trading day of Tokyo Stock Exchange of 1989, Japanese stock market and economy has been in decline. In 2003, Japanese economy appeared to have hit bottom but the recovery remains fragile. People often refer to this long recession during the 1990s as the “lost decade.” Business and government each made a lot of effort to end the recession but in vain. Although the situation appeared quite static, many changes were actually taking place during the lost decade. This process came to a head and became apparent in 1997. Why 1997? Although perhaps somewhat arbitrary, most students of Japan now recognize 1997 as a year of turnaround.

This article has three aims. The first aim is to explain why the traditional Japanese corporate governance system (traditional J-model) began to malfunction and suggest that a new Japanese corporate governance system (new J-model) is presently emerging. The second aim is to examine the relationship between the corporate governance practice and the reforms of corporate law since 1997. Finally, the third aim is to argue that the recent history of the Japanese case runs contrary to
predominant arguments about the convergence of corporate governance systems. A growing
literature predicts that corporate governance will undergo functional convergence even when a
formal convergence of legal rules does not occur (Gilson 2001). Recent reforms of Japanese
corporate law have, in fact, introduced substantial elements of formal convergence, whereas
corporate governance continues to display functional divergence due to differences in the
incentive patterns of major corporate stakeholders.

Next, Chapter II will show discuss trends in Japanese corporate governance practices during
the lost decade and why 1997 culminated in a turning point. Chapter III reviews corporate law
reforms since 1997 and discusses their significance for the change of corporate governance
practice. Chapter IV discusses this current history of Japanese corporate governance in the
context of debates over the international convergence of corporate governance and suggests that
Japan is moving toward a new J-model. Chapter V summarizes the main conclusions of this study.

II. The Lost Decade and the Turning Point

The traditional J-model can be described as a contingent corporate governance system based on
the notion of a “company community.” It is not only in Japan, but also in other countries, that the
providers of human capital, i.e., management and employees, organize a kind of team and share a
common interest maintaining their autonomy from the investors who provide monetary capital,
i.e., shareholders and creditors, who share a common interest of obtaining stronger power to monitor the team of human capital providers. The uniqueness of the traditional J-model is that the human capital providers do not simply organize a temporary team, but create a long-lived community (Shishido 2000).

The common desire of the company community to keep their independence is so strong that the monetary capital providers have been forced to respect their autonomy. Actually, it was also the benefit of the monetary capital providers. Japanese firms have boards made up of insiders and normally have no outside director. Only in the case of bad performance by the company community such as a large business loss or large declines in stock price does the main bank or major keiretsu shareholders intervene and force the company community to accept outside directors (Kaplan & Minton 1994). Such a practice is called “contingent governance” (Aoki 1994), which gives human capital providers an incentive to work hard to avoid intervention by the investors of monetary capital. Such a system worked well as long as Japanese economy was in a phase of high economic growth.

The Japanese contingent governance system, however, ran into serious difficulties after the economic growth slowed in early 1980s. Particularly, the old J-model had trouble in monitoring the use of free cash flow and firms wasted large amounts of cash during the bubble economy (Gilson & Roe 1993). In the 1990s, after bursting the bubble, shareholders came increasingly to
the fore with their complaints for the company community, either by exit, like dissolving cross-shareholding, or by voice, like US style institutional investors activism.

At the same time, two important environmental changes were going on. On the investors’ side, the role of the main banks was changing. Banks had acted the delegated monitoring to coordinate and undertake monitoring among the monetary capital providers. However, banks lost their ability to act as an effective monitor because of their bad loan problem, as well as problems in their own internal governance.

In fact, the main bank relationship itself created perverse incentives. Once a main bank gives a large loan to a specific firm, the main bank cannot let the firm bankrupt even when the firm faced serious financial distress. Many such cases existed during the lost decade, particularly in construction industries, where the main bank not only waived its own loan, but also solicited other banks to write-off their loans to the failing firm. Since company insiders providing human capital to such financially distressed firms could anticipate the bank behavior, they faced little incentive to change their moral hazard behavior even after management had clearly failed.

On the side of employees and inside managers providing human capital, the company community had also begun to change. Employment became less secure. Although firms usually avoided outright lay-offs, they adjusted employment more quickly and frequently through early retirement or transfers. Secure jobs often came at the price of pay-cuts. As a result, employees
began to feel that companies had breached implicit contracts and as a result their psychological
attachment and loyalty to the company community started loosening. However, the liquidity of
external labor markets remains small, even though job change is no longer a rare case in some
industries such as finance. And most board members are still promoted internally from among the
company employees.

What happened in 1997? 1997 was the very memorable year for many Japanese people. A
number of watershed events happened in the same year that changed the predominant mood. It
looked like an apple, which had been ripening, fell at last.

The biggest impact was made by series of failures by major financial institutions. In particular,
the bankruptcy of a major city bank, Hokkaido Takushoku Bank, and dissolution of a big four
securities firm, Yamaichi Securities, shocked the Japanese public. Most Japanese believed that
the government would never let such major financial institutions fail. So first of all, 1997 was the
year that the Japanese government started to let major financial institutions fail.

This change of government policy changed banks’ investment policy. Japanese banks, as major
players of cross shareholding networks, used to keep holding stock of their partner companies,
regardless of its bad performance in the stock market. After the financial crisis, the Tokyo stock
market declined further and the major decline in the asset value of such shares pushed the banks
into crisis. Given the pressure of the BIS regulations, Japanese banks were forced to sell off many
1997 was also the year that rapid deregulation of corporate law started. Corporate law reforms are most often the products of market pressure. The introduction of stock options in 1997 was a particularly symbolic case, as it was the first corporate law reform initiated by a Diet member. Historically, corporate law reforms have been initiated by the Ministry of Justice after long debates at its Legislative Counsel, in which academic lawyers have been very influential. But in the case of stock options, business associations lobbied the Diet and the legislation was passed very quickly. Subsequently, corporate law reform has become much faster even when the Legislative Counsel of the Ministry of Justice is involved.

Last, in 1997, voluntary reform of corporate governance practice were started by Sony and other several companies with many foreign shareholders. Younger executive directors were demoted to “executive officers (shikko yakuin)” and the number of board members was decreased. This step represented an attempt to separate day-to-day management and monitoring. Although it was imperfect, this step has made the board of directors a real seat of decision-making. This type of reform, which is called “executive officer system (shikko yakuinn sei),” has been followed by many publicly held companies. Several leading companies even introduced outside

---

1 Interestingly, banks did not necessarily sell off bad performance stocks. They sold very bad performance stocks and very good performance stocks, then kept mediocre stocks (Miyajima Haramura, & Enami 2003).

2 Japanese board traditionally had no concept of separation of management and monitoring except statutory auditor, which has no voting right and is, in practice, mostly ex-employee.
directors and a committee system before the corporate law reform of 2002.\(^3\)

On the whole, 1997 marked a major shift in thinking. Japanese people, particularly, members of company communities, clearly recognized that shareholders cannot be ignored and that corporate governance reform is inevitable. Since then, as a result, the convergence of at least the formal rules regarding corporate governance has progressed substantially. As shall be discussed later, such formal convergence has not necessarily resulted in the functional convergence of corporate governance practices.

III. Corporate Law Reforms since 1997: Demand-Pull Reform and Policy-Push Reform

In a previous article, I examined the relationship between legal reforms and corporate governance practice over 100 years history of Japanese corporate law by using the analytical framework of “policy-push” reform and “demand-pull” reform (Shishido 2001). Policy push reforms are those initiated by the legislature in a broad sense to change the practice. The demand-pull reforms are those initiated by the business sectors to enable a new practice that could not be done under the current legal rules. A key finding was that on one hand, most demand-pull reforms were strongly linked to changes in business practice, because practice was a cause of the reform effort and reform had a further effect to enable or support such change. On the other hand,

\(^3\) For examples, Sony, Orix, Teijin, and Hoya.
policy push reforms only rarely had a strong influence on business practice. This article extends this framework for analyzing the corporate law reforms since 1997.

Demand-pull reform of corporate law can be categorized into two types. First, some reforms are based on the interests of management or of human capital providers as a whole, particularly in order to protect their autonomy from intervention by outsider investors. The demands of the business sector for reform come mostly from the management and core employees of major publicly held corporations. They have their own lobbying organization, named Keidanren,\(^4\) which has a seat at the Legislative Counsel of the Ministry of Justice. Second, some demand-pull reforms target the interests of shareholders and thus increase pressure on management. In either case, most demand-pull reforms take the form of deregulation of mandatory laws and thus enable new business practices.

Policy-push reform is largely developed through the legislative process that involves legal bureaucrats, who are either judges or prosecutors, and academic lawyers. These corporate law reforms can also be categorized into two types: reforms to improve the monitoring management and reforms to protect the interests of minority shareholders. Most policy-push reforms consist of mandatory regulations that prevent or require businesses from adopting particular practices.

\(^4\) Keidanren is the major management organization for large companies. Generally speaking, they represent the interest of traditional big companies.
1. Repurchase of Shares

The repurchase of shares by a company had been basically prohibited with a few exceptions. Although business sectors had pushed the legislature toward deregulation of share repurchases, particularly academic lawyers had strongly resisted deregulation because it would violate some basic “principle of corporate law.”

In 1994, some exceptions to the prohibition of share repurchases were added, such as repurchases for selling to employees or for stock redemption by the shareholder meeting. In 1997, an important exception was added to let publicly held corporations repurchase their shares for the purpose of redemption based only by on the decision of the board. Finally, in 2001, share repurchases become basically unrestricted within the bounds of profit payable as dividend and subject to a few procedural rules. Even the resale of treasury stock was deregulated.

It was a typical demand-pull reform and had a huge and immediate impact on the practice of corporate finance. From April 2002 to March 2003, 1652 publicly held corporations voted to authorize stock repurchases within certain limits and 972 companies actually repurchased their own stock for a total amount of more than 3000 billion yen (Shigemi Ozawa, The Situation of Stock Repurchases in 2002, Shinko Research Institute, Jun. 26, 2003). In sum, share repurchase has become a common instrument of many Japanese corporations.

Why did management demand the power of repurchase of shares? Provably, the primary
objective was to keep their companies’ stock price high during the long recession through the effect of signaling. In addition, management can have the company buy the shares that are being sold off by its cross-shareholding partners. A recent survey of companies regarding stock repurchase confirmed that around 60% companies authorizing share repurchases did so with the intention of buying stock that was being sold by their mochiai partner (Masashi Kohara, The Purpose of 60% Stock Repurchasing Firms is for Taking Care of “Mochiai Dissolution” (Shinko Research Institute, Sep. 8, 2003)). Another less overt purpose for share repurchases may be for use as a defense against hostile takeovers. While these purposes may serve the self-interest of management, they also constitute a way of returning free cash flow to shareholders other than dividend. Thus, they are part of management response to the strong pressure of the capital market.\(^5\) Not only in Japan, but also in the United States, management tends to prefer share repurchases over paying higher dividends because once management increases dividend, it becomes difficult to decrease dividend later without incurring a negative reaction by the stock market (Fried 2004).

From 1997 to 2001, two different methods of stock redemption were thus available for publicly held corporations. The formal way required a resolution of annual shareholder meeting, but no limitation was placed of number of repurchased stock. The less formal way only requires a

\(^{5}\) For example, Canon, which has more than 40% foreign shareholders, repurchased shares in 2003 for the purpose of “returning free cash flow to our shareholders.” Nikkei 2003. 11. 27. at 1.
resolution of board meeting, but repurchased stock was limited to 10% of issued stock. A recent study suggests that companies adopted the formal method of approval by the shareholder meeting when seeking to return their free cash flow to their shareholders, whereas companies used the informal way of stock redemption when seeking to send the stock market a signal of undervaluation of their stock (Hirose, Yanagawa, & Saito 2003).

2. Stock Options

In 1997, stock options were introduced to Japan. Initially, stock options remained very restricted. For example, issuing stock options was limited either to directors or to employees. Nonetheless, deregulation of stock options introduced the concept of the equity incentives and opened a way of aligning interests between shareholders and human capital providers. In 2001, stock option was totally deregulated (e.g. no necessity of attaching to bonds) and now can be issued to anybody. As a result, stock options can also be used as poison pills although no such cases can be observed thus far.

Introduction of stock options was a demand-pull reform that had particular symbolic importance, because corporate law reform was initiated directly by members of the Diet for the first time. These Diet members were responding directly to lobbying by business sector. Management can use stock options to different ends. Stock options can be used to provide additional remuneration, thus serving the self-interest of company insiders. But stock options can
potentially also help to resolve agency problems by aligning the interests of managers and human capital providers to the stock market. In any case, stock options have become widely used. From their introduction of 1997 through June 2004, some 1303 companies or 36% of publicly held corporations have issued stock options.\(^6\)

Previously, Japanese companies never utilized this type of equity incentive as a scheme for motivating human capital providers because human capital providers were sufficiently motivated by the company community concept of the traditional J-model. Although it is too early to evaluate its effect on Japanese companies, several characteristics of Japanese stock options can be identified. First, stock options are given very widely, not only to directors and officers, but also to core employees. Second, for directors and officers, stock options remain only a small percentage of their total salary. Third, the gap between option price and current price is small. Forth, option term is relatively short, such as around 4 years. And fifth, companies adopting stock options are mostly market oriented and high performance companies, such as Toyota and Matsushita (Miyajima & Kuroki 2004).

3. Corporate Reorganizations

Since 1997, measures to reorganize corporate groups have been rapidly deregulated and a greater variety of reorganization schemes became available for shareholders and management.

\(^6\) See Nikkei 2004. 6. 24., at 17.
These reforms were mostly demand-pull and have been used widely, although with some exceptions. Management has lobbied for wider discretion in corporate restructuring needed to change the boundaries of corporate groups. And even in Japan, friendly mergers and acquisitions have been increasing. Managers have thus been seeking convenient tools for that purpose.

Corporate reorganization, both within a single corporate group and between different groups, have been pushed by intense product market competition and pressures of the stock market.

_Deregulation of Mergers._ In 1997, procedures for mergers and acquisitions were simplified. One of the two shareholder meetings required to approve for a merger, called “meeting for reporting shareholders,” was abolished. Requirements for notify individual creditors were also abolished. And short-form mergers were permitted, whereby the approval of the acquiring company’s shareholders is not required if the size of the acquired company is less than 5% of the acquiring company.⁷

_Holding Companies._ The prohibition of holding companies, which had a huge effect on post-war Japanese corporate governance, was also lifted in 1997. The Anti-monopoly Law had banned holding companies since 1947. The ban was introduced by the Allies, who considered _zaibatsu_ holding companies to be one of the biggest evils in pre-war Japanese society.

Obviously, the holding company structure is one of the reasonable alternatives for the

---

⁷ Japanese short-form merger is different from American short-form merger, which is permitted if the acquiring company already owns most of the acquired company’s stock.
governance of conglomerate firms. Big Japanese companies have diversified their business, but were forced to adopt a group structure consisting of subsidiaries governed by a parent company that has its own core business (“holding company with business”). Conflicts of interest problems often occur between the core business of the holding company and its subsidiaries. The pure holding company structure has fewer conflict of interest problems and may be a better choice in many circumstances. Nevertheless, even after the trauma of zaibatsu was gone, the prohibition of genuine holding company continued for 50 years.

Despite its potential strengths for monitoring subsidiaries, the pure holding company structure has been adopted less than would be expected from a typical demand-pull reform. Until September 2002, only 23 listed corporations either adopted or announced plans to adopt the holding company structure (Miyajima & Inagaki 2003). Among those multi-divisional companies with an in-house company system, the majority of companies have retained the in-house system and not yet reformed it into the formal holding company system. The major reason is probably that the concept of an autonomous of the company community in Japan tends to be applied to each corporation, even if it is wholly owned subsidiary. In this sense, many expect the holding company to be a weaker monitor than the head quarter of in-house company system.

Holding companies have also been used as an important means to implement mergers and
acquisitions. In Japan, the concept of “company community” is still strong and members of the company community typically resist the idea that their company will be merged to another company and disappear. Merging through the creation of a holding company together is more easily acceptable by company communities.

The holding company can be expected to affect Japanese corporate governance in two ways. First, in the context of internal reorganization of a corporate group, the holding company will play a role like the venture capitalist in the Silicon Valley Model, i.e., both as a professional monitor and as a go-between for the monetary capital providers and the human capital providers. Second, in the context of mergers and acquisitions, the holding company will provide the members of both company communities the time to prepare for real integration following a merger.

**Share-for-Share Exchanges (Stock Swaps).** In 1999, share-for-share exchanges were introduced to facilitate the creation of holding companies. This new scheme can also be used for creating wholly owned subsidiaries by making acquired company’s shareholders to be parent company’s shareholders without their agreement.

Stock swaps now give Japanese companies a new convenient tool for mergers and acquisitions. Listed companies can acquire other companies without using cash. In Silicon Valley, Cisco...
Systems has grown rapidly by using this method to acquire many start-up companies using a strategy called “acquisition and development.” Since its introduction, mergers and acquisitions between Japanese companies have been increased dramatically and involved a number of prominent cases of share-for-share exchange.\(^{11}\)

Deregulation of stock swaps is another example of demand-pull reform. Without share-for-share exchanges, creating holding companies would require very complicated procedures. Second, management has been seeking some tool for creating wholly owned subsidiaries because the existence of minority shareholders makes a lot of problems. And third, a tool for acquiring other companies without cash is attractive for management of publicly held companies\(^{12}\).


\(^{12}\) Although their companies could be targets of acquisitions, share-for-share exchanges could basically be used only for friendly acquisitions because they need special resolution (two thirds majority) of shareholder meeting.
Corporate Divisions. In 2000, another new convenient tool for reorganization of corporate groups and mergers and acquisitions were introduced. The newly implemented legal scheme of corporate division, which is German origin, can be used for various purposes: creating wholly owned subsidiaries, creating and dissolving joint ventures, American type spin offs and split offs, transferring a business unit to another company, etc. (Takei & Hirabayashi 2000)

In practice, corporate divisions are frequently used for creating wholly owned subsidiaries because the new scheme can skip the notorious inspection by the court on transfer of business to a newly created company, which is ordinary required by the Commercial Code.

So far, however, corporate divisions have almost never been used for American type spin offs and split offs, which create separate companies without any controlling relationship each other. There are two reasons. First, such reorganizations will cause tax effects, not only on the dividing corporation by realizing capital gain, but also on the shareholders by receiving dividend\(^\text{13}\). Second, they mean the division of “company community.” Human capital providers in most Japanese companies still keep the team concept of company community and would not want to divide their team even though spin offs may increase shareholders’ interest (Hite & Owers 1983; Shipper & Smith 1983; Miles & Rosenfeld 1983; Vijh 1994; Aron 1991; Cusatis, Miles & Woolridge 1993).

This law reform was a demand-pull reform on the part of creating wholly owned subsidiaries

---

\(^{13}\) Chugai Pharmaceutical made spin-off its bio unit, which was provably the only one case of spin off in Japan after the law reform so far, and was forced to pay enormous tax. See Nikkei 2003. 7. 27., at
and creating joint ventures because management demanded a tool for skipping formal procedures.

On the other hand, this reform was a policy-push reform on the part of spin offs. The legislature
prepared the tool, which logically should be there and may enhance the interest of shareholders,
before management and human capital providers actually demanded. A characteristic of this
policy push reform is its enabling nature, while most policy-push reforms are creating mandatory
laws.

4. Accounting Reforms

Accounting rules have been also reformed and the transparency of Japanese companies has
increased since late 1990s. In 1997, consolidated accounting was required by the Securities
Regulation, and, in 2002, it was also required by the Commercial Code. Consolidated accounting
changed mind of Japanese management and investors who used to appreciate the performance of
management by individual company basis. In the Commercial Code Reform of 1999,
mark-to-market accounting for financial assets was required. This reform had a significant impact
towards the dissolving cross shareholding. The reform gave strong impact particularly on banks,
which were forced to meet the balance sheet requirement by BIS. Management of non-financial
companies was also forced to recognize the volatility risk of holding mochiai stock.

These are typical policy-push reforms. Although management never wanted these reforms, the
legislature changed the laws with a pressure of internationalization of accounting rules. These are rare cases, as policy-push reforms, which substantially affected the practice.

5. Corporate Governance Reforms

*Limiting Directors’ Liability.* Since the famous reform of 1993, which fixed the filing fee of shareholder derivative actions at 8200 yen on whatever amount of damages are sought, the number of shareholder derivative actions in Japan has increased dramatically. Japanese management has claimed the “chilling effect” of the law suits on their business judgment and tried to decrease the fierce of the law suits. Particularly after the district court decision of Daiwa Bank Case, which ordered directors of Daiwa Bank to pay astronomical amount of damages, business sectors seriously lobbied for gaining some relief. As a result, the corporate law reform of 2001 allowed companies to put upper limit of damage on negligence of their directors by amendment of their bylaws.

Although this is a typical demand-pull reformation, the new law is a kind of compromise after the bargaining between business sectors and legislatures. Ex ante limitation, up to two times of one’ annual remuneration, can be put only on outside directors. Limitation of liability of inside directors, up to six times of one’s annual remuneration in case of representative directors and up to four times of one’s annual remuneration in case of non-representative directors, can be allowed ex post either by resolution of board of directors unless there is no objection of more than 3%
shareholders or by special resolution of shareholder meeting.

This reformation has two important significances on Japanese corporate governance. First, ex ante limitation of liability of outside directors opened the possibility of monitoring system based on outside directors. Second, this reform provided Japanese management with quasi business judgment rule because management risk can be limited unless there is no illegality and gross negligence.\(^\text{14}\)

**Strengthening Statutory Auditors.** The statutory auditor system was strengthened again in 2001. It is true that the history of Japanese corporate governance law reform was the history of strengthening statutory auditors (Shishido 2001), and the reform of 2001 was the most fundamental changes among them. By this reform, Japanese large companies must have “real” outside auditors who must be at least half of all auditors after May 2005. Although outside auditors have already been required since 1993, most large companies chose ex-employees after 5 years of their retirement according to the definition of “outside auditors” of the Commercial Code. Company communities have been able to enjoy genuine insider boards even after the reformation of 1993. The reform of 2001 was the first legislation, which intervened in the company community.

Of course, members of company communities have never wanted to be forced to accept

---

\(^{14}\) Although, in the United States, the business judgment rule prohibits courts from second guess reviewing adequacy of business judgment, adequacy of business judgment is often reviewed by the
outsiders in the board, even they are quasi board members without vote. The legislatures forced business sectors accept this reform, provably as a prerequisite of the limitation of directors’ liability, which was enacted at the same time. Actually, for changing bylaw to implement the limitation of directors’ liability, agreements of all statutory auditors are necessary. Therefore, it was a typical policy-push reform.

Although its practical effect is too early to be evaluated because the new law has not yet been effective at this stage, it will have a huge impact on Japanese corporate governance. After the new law turns to be effective, a Japanese large company has to have at least two outside auditors and provably two inside auditors because the company community would never want an outsider majority auditors board. Practitioners expect that a company will have three outside auditors for the case of accident of some outside auditor and have three inside auditors. It means that a Japanese large company will have six auditors who provide illegality monitoring only, as long as it does not turned to be a company with committees. Two things are expected. First, this reform will have some pressure on traditional companies with statutory auditors to adopt the board with committees. Second, this reform will make the contingent governance difficult because Japanese large companies will be forced to always have at least two real outsiders (non-members of company communities) at their boards (as quasi members), even company communities keep court in Japan.
good performance.

Board with Committees as an Option. In 2002, an epoch-making law reform on Japanese corporate governance was made. The American style board of directors, which is called “board with committees” in Japan, was introduced as an option in addition to the traditional Japanese style board with statutory auditors.

Japanese traditional board system with statutory auditors, who have no vote and are only in charge of illegality monitoring, have been perfectly fit to Japanese contingent corporate governance system based on company community. In the traditional system, there is little distinction between management and monitoring in the board. Directors are simply the highest hierarchy among management and at the same time among the company community. Therefore, the board is an insider board without any outside director normally. Only in the case of bad performance by the company community, main bank or major keiretsu shareholders force the company community to accept outside directors.

There are three major characteristics of the new board system with committees being compared with the traditional board system with statutory auditors.

First, the new system is much clearer in distinction between day-to-day management and monitoring than the traditional system. While in the traditional system, every management must be a director, in the new system, management, which is called an officer, is not necessarily a
director.

Second, outside directors, who are never been employees and officers\textsuperscript{15}, are expected to play an important role of the corporate governance. Outside directors must be the majority in all three committees: audit committee; nomination committee; and remuneration committee, whose decisions are final and even the board of directors cannot change them.

And third, management has wider discretion than its counterpart in the traditional system. In the traditional system, the board of directors must decide a lot of business decisions, such as sale of important assets and issuing new stock, because it is the managing board. On the other hand, in the new system, the board of directors can delegate many day-to-day management decisions to the management (officers) and the board can concentrate on major policy decisions, which are indispensable for monitoring management.

As I already mentioned, the board with committees is not the mandatory choice, but an option for large companies, which can stay with the traditional board with statutory auditors. This reform, however, being combined with the reform of strengthening statutory auditors, has a significant mandatory nature because Japanese large companies will, in any event, have to accept at least two

\textsuperscript{15}So far, the definition of outside director in Japan is quite simple. Two points are criticized. On one hand, “never” been an employee is too extreme. On the other hand, there is no requirement for “independence,” such as no affiliation and no family tie. It makes sense as a first step, however, because the company community has been so strong and the monitoring company community by non-member of the company community is the most important reform in the context of Japanese corporate governance. A company community is organized per company, i.e., legal personality. Management and employees of the parent company are not members of its subsidiary’s company community (See Itoh & Shishido 1999). The protection of minority shareholders of publicly held
real outsiders, either as the real board members or as the quasi board members, to their board. It means that legislatures finally intruded into the fort of company communities.

Therefore, these reforms as a whole, which made outsiders (either as real members or as quasi members) in the board mandatory, were typical policy push reforms. However, the nature of the reform of introducing the board with committees, which simply opened a new alternative, is a bit complicated. Although the law reform was initiated mainly by academic lawyers, and Keidanren was indifferent towards the idea, another group of business sectors, which had been seeking alternative board systems, welcomed the new system\(^{16}\). It actuary had the characteristics of “demand-pull” reform, too. Since 1997, after the contingent governance turned to obviously be malfunction, several attempts of reforming the corporate governance system, particularly, reforms of the board system, had been made by the companies with many foreign shareholders, like SONY. They decreased the number of directors, accepting outside directors, and introducing committees, under the legal system for traditional Japanese board with statutory auditors\(^{17}\). In the first year after the law reform, 55 publicly held companies, much more than being expected, chose

---

\(^{16}\) For example, Japan Association of Corporate Directors was founded in 2002 by non-traditional publicly held companies, such as Orix, Sony, and HOYA, and has been active in promoting the new board system with committees.

\(^{17}\) According to the interview by mail research by Tokyo Stock Exchange (http://www.twe.or.jp/listing/cg/enquete/index.html), in November 2002, just before the board with committees was formally available, among 1363 companies, 494 (36.2 %) companies decreased the number of directors, 466 (34.2 %) companies adopted the executive officer system, 388 (28.5%) companies elected outside directors, 54 (4.0 %) companies adopted remuneration committees, and 33 (2.4 %) companies adopted nominating committees.
6. Summery

We have reviewed reformations of corporate law since 1997 from the point of view of distinction between demand-pull reforms and policy push reforms. Now we can pick up a couple of characteristics of those reformations.

First, most of those reformations, such as deregulations of repurchase of shares, stock options, and reorganization schemes, were demand-pull reforms. In other words, business sectors demanded these deregulations of what had been prohibited by Japanese corporate law, which has a lot more mandatory nature in comparison with American corporate law. Japanese management wanted to do what American management can do. I already pointed out, in my previous article, such phenomenon that the mandatory nature of Japanese corporate law was partly changed by the demand-pull reforms in 1990s. I called it “internal Americanization” (Shishido 2001). This type of reformations is continuations of the demand-pull reforms since early 1990s.

Second, there were several important policy-push reforms, such as accounting reforms and corporate governance reforms, which are new trends since 1997. Japanese legislature introduced new corporate governance schemes by international, particularly American influence, during the period when the malfunction of traditional Japanese corporate governance system turned to be obvious. The historical significance of these reforms is that the legislature finally intervened in
the company community centered governance system, which could not be changed without mandatory law approach, from the point of shareholders’ interest. These corporate governance law reforms, in spite of their policy-push nature, are expected to have significant effects on practice because not only they force company communities to change their traditional practice, but also they look like being responded to the hidden demand of business sectors. I will call such phenomenon “a new trend of Americanization.”

As a whole, Japanese corporate law, as a legal infrastructure, has been approaching to American corporate laws. Although there are a lot of facial differences between the two corporate laws, now Japanese companies almost could do as American companies do.

IV. Formal Convergence and Functional Divergence

1. Convergence of Corporate Governance Debates

Interesting debates on convergence of corporate governance in the world have been made for the last decade (Bebchuck & Roe 1999; Rameyer 1998; Gilson 2001; Coffee 1999; Hansmann & Kraakman 2001). Nowadays the participants to the debates realized that they should distinguish between the formal convergence on legal system and the functional convergence on practice, and the predominant view is that even the formal convergence could not be made, the functional convergence will occur (Gilson 2001; Coffee 1999). Two main topics of the functional
convergence debate are the concentration of share ownership and the labor influence (Bebchuck & Roe 1999).

The concentration of share ownership is converging between the United States and Japan. Although dispersed share ownership is used to be a typical characteristic of American corporate governance, institutionalization of share ownership has been accelerated since 1980s (Coffee 1991) and now, more than 50% of publicly held stock is owned by Institutional investors in the United States (Miyajima 2004). On the other hand, cross shareholding has been dissolved and individual shareholders and foreign shareholders have been increased in Japan since 1990s. In 2000, the difference of institutional holding ratio (including non-financial firms) in both countries was less than 10% (Miyajima 2004).

The labor influence on corporate governance looks still far different between the United States and Japan. Although turnover of core employees in financial industries has been a bit increased since late 1990s, the liquidity of external labor market in Japan is still without comparison with American counterpart. The concept of “company community” is still remained and plays an important role in corporate governance.

2. Formal Convergence of the Legal System

As we saw in Chapter III, formal convergence of corporate law to the A-Model has been almost accomplished via numerous law reforms since 1997. Although vast majority of Japanese publicly
held corporations still keep the traditional board with statutory auditors, the important thing is that
they can choose American type board with committees at any time. By these law reforms, not
only on the board system, but also on corporate finance and mergers and acquisitions, Japanese
companies now can do as Americans do. What they actually choose, and whether it means
functional convergence to the A-model or not, are different questions.

3. Functional Divergence of the Incentive Pattern

The “strong convergence” theses argue that world corporate governance will converge or
already have converged to the A-model (Hansmann & Kraakman 2001). In the A-model,
shareholders, as the owner, monitor their agent, i.e., management, to run the company only in
their best interest, either by the threat of hostile takeover, by outsider super-majority board, or by
the incentive of performance-based compensations. Other stakeholders, creditors and employees,
should be motivated through markets and should not be involved in the corporate governance.
Because of such characteristics, the A-model are often called either “monitoring model” or
“market oriented system.”

Contrary to the prediction and the recognition by those strong convergence theorists, however,
“there is little sign that Japanese corporate governance practices are being fundamentally
transformed or rapidly ‘converging’ with those of the United States” (Milhaupt 2003).

In the convergence of corporate governance debate, diversity of stock ownership is mostly
argued as the criteria of functional convergence. However, the most fundamental aspect of functional corporate governance system, which can be chosen by the players under certain exogenous conditions, is how to motivate monetary capital providers and human capital providers to invest their own capital to the company. I will call the aspect “incentive pattern.” Diversity of stock ownership (and liquidity of stock market) is rather one of the exogenous factors, which restrict the choice of incentive pattern.

From this point of view, neither the convergence of stock ownership diversity between the U.S. and Japan, nor the choice of the American type board system by many Japanese companies means the functional convergence of corporate governance. Although such superficial aspects look like to indicate the functional convergence of corporate governance between the two countries, incentive patterns are still diverged and may not be converged in the near future.


In the “lost decade,” as we have seen in Chapter II, the traditional J-model turned to be mal functioned. Should Japanese firms now choose the A-model? Not necessarily.

First, the A-model or the monitoring model needs some exogenous prerequisites to be chosen. Liquid stock market and labor market are very important for the A-model. Besides the aspect of monitoring management by the stock market, human capital providers are supposed to be

---

18 Actually, choice of the board system is diverged even among the companies with many foreign shareholders. While Sony and HOYA, for examples, chose the American type board with committees,
motivated by the labor market. Because there is still no liquid labor market in Japan, at least so far, there is lack of prerequisite for Japanese companies to choose the A-model as the incentive pattern.

Second, although the A-model may be pretty good at the industry with little relation specific investment, such as Wall Street type financial industries, it is not necessarily efficient for certain types of manufacturing industries, in which relation specific human capital investment is indispensable. Although relation specific investment can be motivated by performance pay contracts and severance fee contracts, they are second best. Because relation specific skill cannot be sold at external labor market, the hold up problem tends to occur.

Manufacturing systems can be divided into two categories: the “modular” type system and the “integral” type system. In the modular type system, manufacturing companies just assemble parts, which are obtained from markets. On the other hand, in the integral type system, manufacturing companies fine tune different parts for specific purposes (Fujimoto 2003). While the former system needs little relation specific investments, the latter system requires relation specific investments a lot.

Japanese companies traditionally have their competitive advantage in manufacturing industries, to which the integral system is well fit. Therefore, it is necessary for Japanese companies in such Toyota, Honda, and Canon, for examples, keep the traditional board with statutory auditors.
industries to motivate human capital providers to make relation specific investments, for which purpose market approach would not work well.

If the liquid labor markets are developed in the future, it is possible for the Japanese companies in financial industries and certain types of manufacturing industries, to which the modular type system is well fit, to choose the A-model. It is, however, not adequate for the Japanese companies in the industries, which heavily requires relation specific investments, to choose the A-model. They had better keep the relationship-oriented system, where monetary capital providers and human capital providers bargain each other to motivate other party to invest their capitals, even for relation specific purposes. Therefore, even in a same country, optimal corporate governance system would be diverging depend upon industry sector.

The major problem of Japanese corporate governance during the lost decade was its contingent governance aspect. The contingent governance will work best in the era of economic expansion or rapid growth, but will not work when the economic growth stops. The contingent governance does not make sense for monitoring the use of free cash flow because there are always conflicting interests between human capital providers and monetary capital providers on that issue.

As the new J-model, I would like to propose to keep the relationship-oriented system and abandon the main bank contingent governance. The corporate governance law reforms since 1997 have offered Japanese firms a wonderful opportunity for that purpose. Stock options can be the
new scheme to motivate human capital providers to make relation specific investment. Management, as the representative of human capital providers, obtained wide discretion on financing and reorganization to motivate monetary capital providers to invest more money. By choosing the new board system, Japanese firms could make the board a substantial place of bargaining between the team of human capital providers and the team of monetary capital providers. By encouraging institutional investors, instead of main banks, to be involved in selecting outside directors, and having insider-outsider parity board, instead of outsider super-majority board, Japanese firms could have the real “bargaining board\textsuperscript{19}.”

Human capital providers and monetary capital providers need to bargain in any event because both sides need the capital, which could be provided only by other side. Management, as the representative of human capital providers, and main bank, as the representative of monetary capital providers, used to bargain outside of the board, for example, at expensive Japanese restaurants for such purposes. Because of the decline of main banks and legal regulations, however, the bargain will be forced to be held at the board.

\textsuperscript{19} The bargaining board is different from the “mediating board” by Blair & Staut (Blair & Staut 1999). While, in their mediating board, directors play a role of neutral mediators of different stakeholders, in our bargaining board, each director play a role of delegate of either human capital providers or monetary capital providers and bargain each other for maximizing the interest of her team and for motivating other team to provide their capital.
At the board, human capital providers and monetary capital providers bargain for maximizing and sharing the add value. Of course, inside directors, as the representatives of human capital providers, will take initiatives, i.e., propose new projects and the way of using free cash flow. Outside directors, as the representatives of monetary capital providers basically keep approving their proposals. Once, however, inside directors breach the implicit contract with outside directors, and propose a project, which is against the interest of monetary capital providers, outside directors will use their veto and reject the proposal. To keep such an efficient equilibrium of the “Folk Theorem,” outside directors must be able to pull the trigger in the case of the breach of contract by inside directors. To keep the trigger, outside directors must be at least half of board members.

The critical point is how to elect outside directors, who would actually represent the interest of monetary capital providers. Institutional investors are expected to play an important role for that purpose (Black 1990; Gilson & Kraakman 1991; Coffee 1991). In Japan, numbers of Institutional investors are increasing and they are turning to be active in using their voice for the corporate governance. They already vote against the proposal of outside directors, who would not work as their representatives. Further more, the legal rules should not discourage, but rather encourage institutional investors to take initiatives of electing outside directors.
V. Conclusion

The traditional J-model, whose characteristic was contingent governance led by the main bank on the company community, began to malfunction in the late 1980s. Although the traditional J-model was very effective for motivating management and employees to work hard and make relation specific investments while the Japanese economy had been expanding and there were no serious conflicting interests among stakeholders, once economic growth stopped, it could not adjust itself to the new situation where serious conflicting interests in free cash flow always exists.

After struggling with this muddy situation, Japanese corporate governance came to a turning point in 1997. Deregulation of corporate law on financing and reorganization and introduction of a board system with committees, a series of changes called Americanization of corporate law, began. At the same time, voluntary reformations of corporate governance of individual companies started.

Although the formal convergence of the legal system to the A-model has been made, the functional convergence of the incentive patterns has not occurred. The short history of Japanese corporate governance since late 1980s provides an opposite case to the predominant theory of the convergence of corporate governance debate, which predicts the functional convergence even without formal convergence.
The evolution of corporate law reforms since 1997 opened the door to creating the new J-model. Considering the exogenous factors, the new J-model will be different from the A-model, which is the market oriented monitoring model. The new J-model will not keep the main bank contingent governance, but will keep the relationship oriented incentive pattern for motivating human capital providers to make relation specific investment. Instead of contingent governance, which does not require any outside director in an ordinary time, the new J-model will have the bargaining board, where the inside directors, who are the representatives of the human capital providers, and the outside directors, who are the representatives of the monetary capital providers, always bargaining and motivating each other to provide their capital to the company.

Reference

Fried, J. (2004), Share Repurchase and Managerial Opportunism (Working Paper, Forthcoming in


