

ZENICHI SHISHIDO

Reform in Japanese Corporate Law and Corporate Governance: Current Changes in Historical Perspective

I. INTRODUCTION

The Japanese economy grew very rapidly after World War II. It reached its heyday in the 1980's, but in the 1990's struggled through a long recession. In a previous article,¹ I raised two questions concerning the Japanese economy in the 1980's and the 1990's. First, until the end of the 1980's, why was the Japanese corporate practice successful in increasing shareholder wealth even though this practice appears to be in opposition to the basic legal principle of shareholder ownership? Second, why was the practice unsuccessful in the 1990's? In that article, I provided a hypothetical explanation. In this article, I would like to trace my theory in the history of Japanese corporate governance, by focusing on the question of how the Japanese legal system, particularly corporate law, has historically affected Japanese corporate governance practice.

In Section II, I will summarize my previous article and set out the typical Japanese model of corporate governance practice in the 1970's and the 1980's. I will also provide a hypothetical explanation of the Japanese enigma. Section III presents the history of Japanese corporate governance, both the legal system and the practice, by dividing the last 100 years into five eras. In Section IV, I will examine how the different characteristics of the legal reforms, whether they are the "demand pull" reform or the "policy push" reform, historically relate to their actual effect on the practice. In Section V, as the conclusion, I will summarize this historical study and its accounting for

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1. Zenichi Shishido, "Japanese Corporate Governance: The Hidden Problems of the Corporate Law and Their Solutions," 25 *Del. J. Corp. L.* 189 (2000).

the two hidden problems of corporate law and how legal reforms have played a significant role in their resolution.

II. THE JAPANESE MODEL

At present, there are no fundamental differences in Japanese and American corporate law. They share the same foundation, that is, shareholder ownership as the end game norm.² In spite of its appearance to others, the Japanese corporate governance practice has always held to this foundation of the legal system of corporations. Differences in the corporate governance practices come from the different solutions of the two hidden problems of the corporate law: balancing monitoring and autonomy of management on the one hand, and balancing human capital and monetary capital on the other. The scheme to solve these problems will be different depending on the background economic markets, social norms, and legal systems.³

While the US system uses the contract system and the law, such as poison pills and anti-takeover statutes, for stabilizing management, the Japanese system uses cross shareholdings. While the US system uses the incentive of equity, such as stock options, for motivating human capital providers, the Japanese system uses the concept of "company community."⁴

The typical characteristics of the Japanese corporate governance are the following (see Figure 1). The core of the corporate governance is the Company Community, which consists of management, board members, and core employees. The shareholders motivate the employees by letting them act as if they were residual claimants. The monitoring system is three-staged: the first stage monitor is the Company Community, the second stage monitor is the main bank, and the third stage monitor is the capital market. I will call such a corporate governance system, which was prevailed in the 1970's and the 1980's, the Japanese model.⁵

In this article, I will trace the historical balancing of these two hidden problems of the corporate law, and particularly focus on the historical relationship between the legal system and corporate governance practice in Japan.

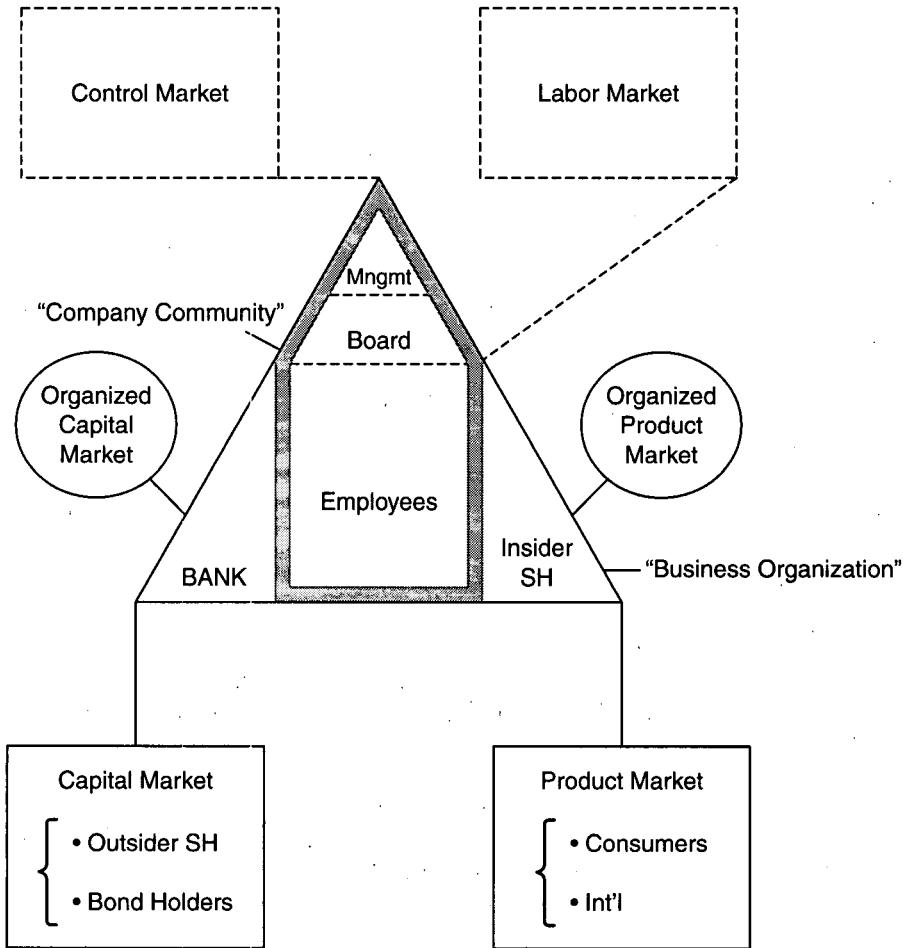
2. Additionally, they share almost the same board system, minority shareholders' rights, and shareholder derivative action. Major differences between the two legal systems, which may have affected the different practices, are the mandatory nature of Japanese corporate law, which has restricted the use of poison pills, allocation of directors to different classes of stocks, the lack of class actions, and the lack of discovery processes in litigation.

3. Shishido, *supra* n. 1, at 25, 33, 46.

4. *Id.* at 25, 28.

5. *Id.* at 14.

FIGURE 1
THE IMAGE OF JAPANESE CORPORATE GOVERNANCE



III. HISTORY OF THE CORPORATE LEGAL SYSTEM AND THE CORPORATE GOVERNANCE PRACTICE

The Japanese Commercial Code, which includes the corporate law, was enacted over 100 years ago, in 1899. A unique characteristic of Japanese corporate law, compared to other laws in Japan, is its experience of many reforms. This is partly because, in general, the corporate law is closely related to its practice, and mainly because Japanese corporate law has a mandatory nature that can be a restric-

tive factor to the practice.⁶ The specific corporate law provisions, which become un-harmonic with practice, must be reformed sooner or later.

The legal reforms can be categorized by two criteria. The first is whether a legal reform influenced the practice or not. The second is who initiated a reform. Some legal reforms were initiated by the legislature in a broad sense to change the practice.⁷ The other reforms were initiated by the business sectors to enable some practice which could not be done within the existing legal system. I will call the former the “policy push” reform and the latter the “demand pull” reform.

I will divide these 100 years into five eras (see Figure 2).

FIGURE 2
ONE HUNDRED YEARS OF JAPANESE CORPORATE LAW &
CORPORATE GOVERNANCE

1872	National Bank Act	I. Classic Shareholder Ownership by Zaibatsu
1899	Commercial Code	
1914	World War I	
1937	Sino-Japanese War	II. Employee Managing Company under Regulations
1945	End of World War II	
1949	Dodge Line Policies	III. Growth Oriented Governance under Dispersed Stock Ownership
1950	Korean War	
	Reform of Commercial Code	
1961	Securities Recession	
1964	Joined OECD	
1965	Yamaichi Crisis	IV. Heyday of Company Community & Main Bank Under Stabilized Stock Ownership
	Increase of Cross Shareholding	
1974	Reform of Commercial Code	
1981	Reform of Commercial Code	
1985	Start of Bubble Economy	V. Post Economic Growth Governance Imperfection & Transition of Corporate Governance
1990	Burst of Bubble Economy	
	Reforms of Commercial Code (90, 93, 94, 97)	
1997	Bankruptcy of Yamaichi	
1999	Reform of Commercial Code	

6. The different nature of corporate laws in the United States and Japan may have led to the different scheme of stabilizing management. 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, is very loyal to the principle of stock majority, it leaves little room for legal arrangements for stabilizing management. Thus, Japanese corporate governance was forced to find different avenues of protection from hostile takeovers, including that of cross-shareholding.

7. One of the unique characteristics of legal reforms of Japanese corporate law is that the Committee of Legal Reform (*Hōsei Shingikai*), which started from 1929, has played an important role. See Shinichi Asagi, “Meiji, Taisho, Showa Zenki no Keizai Shakai no Hensen to Shōhōten: Sensō to Nihon Shihonshugi to Shōhōten [The Changes of Economic Society in Meiji, Taisho, and Showa and the Commercial Code: Wars, Japanese Capitalism, and the Commercial Code]” 71-7 *Hōritsu Jihō* 23, 25 (1999). Because academic lawyers have been very influential in the Committee, there have been many policy-push or theory-push reforms.

A. *First Era: Classic Shareholder Ownership*

The first era is from 1872 to 1937, that is from the enactment of the National Bank Act (*Kokuritsu Ginkō Jōrei*), which created the first modern corporations in Japan, to the Sino-Japanese war. This period is the “era of classic shareholder ownership” (see Figure 3).

FIGURE 3

I. CLASSIC SHAREHOLDER OWNERSHIP

1872	National Bank Act	Governance by Large Shareholders
1876	Mitsui Bank, Mitsui Trading Co.	Zaibatsu Holding Companies
1878	Tokyo Stock Exchange	Hostile Takeovers
1893	Mitsubishi Holding Co.	High Rate Profit-Responsive Dividends
1894	First Sino-Japanese War	Profit-Responsive Management Salary
1895	Mitsubishi Bank, Sumitomo Bank	High Turnover Rate of Employees
1899	Commercial Code Shareholder Meeting-Centered Governance	Joint Stockholding System (<i>Sōyū-sei</i>)
1902	Industrial Bank of Japan	In-house Promotion to Management
1904	Russo-Japanese War	
1909	Mitsui Holding Co.	
1911	Reform of Commercial Code of Meiji 44	
1914	World War I	
1925	Ministry of Commerce and Industry	
1929	Legislation Committees	
1932	Assassination of Mitsui CEO	
1933	Zaibatsu Extends to Northeast China	
1937	Sino-Japanese War	

Important industries were dominated by nine *zaibatsu* families.⁸ *Zaibatsu* families created holding companies which controlled many business companies as major shareholders. They even played a role as raiders.⁹ In the non-*zaibatsu* companies, large shareholders were involved in corporate governance as board members.¹⁰ Dividend rates were high and responsive to profit.¹¹ Management salaries were also

8. They were Mitsui, Mitsubishi, Sumitomo, Yasuda, Furukawa, Nissan, Okura, Nomura, and Asano. See Tetsuji Okazaki, *Mochikabugaisha no Rekishi: Zaibatsu to Kigyō Tochi [The History of Holding Companies: Zaibatsu and Corporate Governance]* 20 (1999).

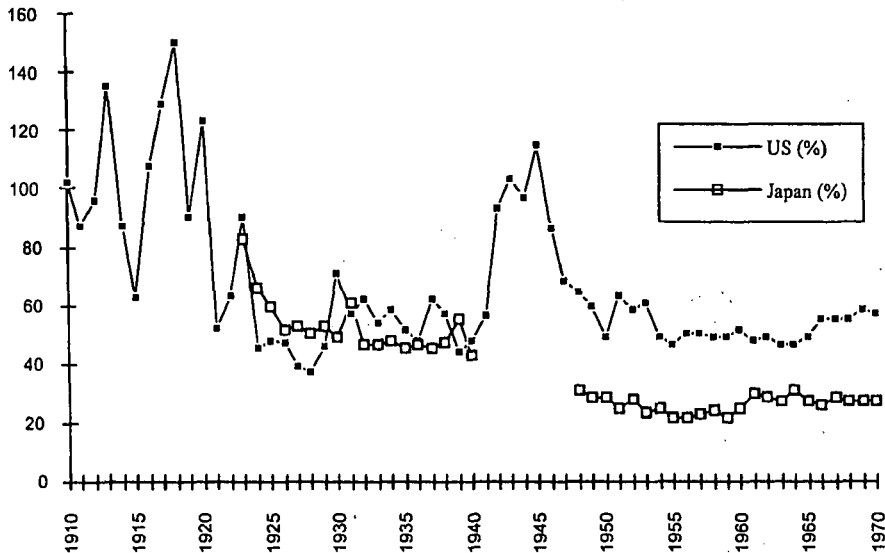
9. *Id.* at 176.

10. In *zaibatsu* companies, although the holding company was involved in the governance of its affiliated corporations, individual *zaibatsu* family members did not intervene in management. Tetsuji Okazaki, “The Japanese Firm under the Wartime Planned Economy,” in Masahiko Aoki & Ronald Dore (eds.), *The Japanese Firm: The Sources of Competitive Strength* 354 (1994).

11. *Id.* at 357. See also Tetsuji Okazaki, “Nihon ni okeru Kōporēto Gabanansu no Hatten [The Development of Corporate Governance in Japan],” in Masahiko Aoki & Ronald Dore (eds.), *Shisutemu toshiteno Nihon Kigyō [The Japanese Firm as a System]* 452 (1995).

responsive to profit.¹² The turnover rate of employees was so high that there was no incentive for workers to commit to corporate governance.¹³

FIGURE 4
ANNUAL TURNOVER RATE IN MANUFACTURING IN THE US
AND JAPAN: 1910-70



Source [from Moriguchi, supra n. 13]

US: (I) 1910-18: Brissenden and Frankel (1920), *Monthly Labor Review* 10, pp.1342-62;

(II) 1919-29: Berridge (1929), *Monthly Labor Review* 29, pp.64-5;

(III) 1930-70: U.S. Department of Labor, *Employment, Hours, and Earnings*.

Japan: (I) 1923-1936: *Nihon Rodo Undo Shiryo* (Historical Data of Labor Movement in Japan), vol.10, II-60.

(II) 1937-40: Ohara Shakai Mondai Kenkyusho, *Taiheiyō Sensōka no Rodōsha Jotai* (The Condition of Workers during the Pacific War), p.41.

(III) 1948-75: Japanese Ministry of Labor, *Monthly Labor Survey*.

1) Turnover consists of voluntary quits by employees, discharges by employers, and layoffs by employers.

2) An annual turnover rate is a percentage of employees separated from a manufacturing establishment within one year [compared] to the average number of employees during the year on the payroll in the establishment.

3) See the sources of Figures 2 and 5 for detailed definitions.

By these characteristics, the majority views this era as the classic shareholder ownership period.¹⁴

12. *Id.* at 450.

13. See Okazaki, supra n. 10, at 357; Okazaki, supra n. 11, at 452. Interesting statistical data, provided by Professor Moriguchi, shows the discontinuity of labor turnover rate between the pre-war era and post-war era (see Figure 4). Chiaki Moriguchi, "The Evolution of Employment Systems in the U.S. and Japan, 1900-1960: A Comparative Historical and Institutional Analysis," Working Paper presented at the Changing Japanese Firm Conference at Columbia Business School, December 1998, at 33-38.

14. See Okazaki, supra n. 11, at 452. See also Yoshiro Miwa & Mark Ramseyer, "Corporate Governance in Transitional Economies: Lessons from the Prewar Japanese Cotton Textile Industry," 29 *J. Legal Studies* 171 (2000).

At the same time, continuity of the Japanese model from this era should be emphasized. In this era, selection of management from among core employees had already begun. The joint stock holding system (*sōyū-sei*) of *zaibatsu* families prevented individual shareholders from intervening in management decisions.¹⁵ Some historians insist that Japanese-style employee-oriented management control already existed in this era.¹⁶

In 1899, the Commercial Code, based on German law, was enacted. Its corporate law put the shareholder meeting at the center of corporate governance.¹⁷ Although in practice a board system was used, the law did not provide for it. Instead, an auditor served as the monitoring system.¹⁸

The business sector had been awaiting the enactment of the original corporate law as the legal basis of its industries. In that sense, it can be called “demand pull” legislation. The legislation also had policy push aspects. In particular, the substance of the law was primarily an imported system. The shareholder meeting-centered governance, which was established by the law, was harmonious with classic shareholder ownership practice.

B. *Second Era: Employee Managing Company*

The second era is from 1937 to 1949. This period covers World War II and the post-war occupation until the Dodge Line policies are enacted. It is the first half of the formative era of the Japanese model. I will call this period the era of “employee managing companies”¹⁹ (see Figure 5).

15. See Takeo Kikkawa, *Nihon no Kigyō Shūdan: Zaibatsu tono Renzoku to Danzetsu* [*Japanese Company Groups: Continuity and Discontinuity from Zaibatsu*] 29 (1996).

16. See Tsunehiko Yui, “Meiji Jidai ni okeru Jyūyaku Soshiki no Keisei [The Creation of the Director System in Meiji Period],” 14 *Keieishigaku* (Business History) 1, 3 (1979); Kenjiro Egashira, “Kigyō no Bokkō kara Daikigyō Jidai heno Shōhō [Commercial Code from the Birth of Firms until the Era of Large Firms],” 1155 *Jurist* 16 (1999).

17. See Masahiro Kitazawa, “Kabushikigaisha no Shoyū, Keiei, Shihai [Ownership, Management, and Control of Corporations],” in Makoto Yazawa (ed.), *Gendai Hō: Hō to Kigyō* [*Modern Law: The Law and Firms*] 66 (1966); Asagi, *supra* n. 7, at 25.

18. Although the auditor system was imported from German law in this era, the German auditor system later became the supervisory board; Germany no longer uses the auditor system. In Japan, the auditor system has been preserved and uniquely developed.

19. See Okazaki, *supra* n. 10, at 373; Okazaki, *supra* n. 11, at 475.

FIGURE 5
II. EMPLOYEE MANAGING COMPANY

1937	Sino-Japanese War	
1938	Reform of Commercial Code of Showa 13	Restriction of Shareholder Power
1939	Company Accounting Control Act	Increased Status of Management & Employees
1943	Munition Corporation Law	Initiating Main Bank Monitoring
1944	Designated Financial Institutes System	
1945	End of World War II Labor Union Law	Succession of Wartime System
1946	Companies Accounting Emergent Response Law Companies Reconstruction Law Corporate Dividends Prohibition and Restriction Act "Management Discussion Board" Property Tax	"Employee Managing Company" Excessive Labor Government Subsidies, Inflation Policy
1947	Purge Act Syndicate Loan Anti-monopoly Law	
1948	Zaibatsu Family Control Elimination Law	
1949	Dodge Line Policies	

Japan initiated the war in mainland China in 1937 and many special wartime laws which restricted corporate governance were enacted. The Company Accounting Control Act (*Kaisha Keiri Tōsei Rei*) of 1940 restricted dividend payment. The Munitions Corporation Law (*Gunjyu Kaisha Hō*) of 1943 released management from shareholders' monitoring.²⁰ In order to allocate the limited available capital, it designated specific financial institutions (*shitei kinyūkikan*) to finance specific firms. As a result, the status of shareholders declined, while the status of management and employees increased.²¹ Also, monitoring by the main bank was initiated.²²

Such wartime laws were typical policy-push legislation and at the same time very influential to the practice. Many observers consider these laws a turning point in the Japanese system and named them "the system of 40's (*yonjūnen taisei*)."

20. The government had the power to ratify elections and dismiss the president. The president could execute shareholder meeting decisions without the shareholders meeting. See Okazaki, *supra* n. 10, at 372; Okazaki, *supra* n. 11, at 456.

21. *Id.*, at 462

22. See Juro Teranishi, "Mein Banku Shisutemu [Main Bank System]," in Tetsuji Okazaki & Masahiro Okuno (eds.), *Gendai Nihon Keizai Shisutemu no Genryū [The Origin of Modern Japanese Economic System]* 61, 71 (1993); Okazaki, *supra* n. 11, at 457

After Japan was defeated in 1945, the Allies required drastic reforms including restrictions of property rights,²³ in which the United States played a major role. *Zaibatsu* holding companies were dissolved and *zaibatsu* family members and their appointees were purged from director and officer positions. Most of their successors were promoted from the core employees. The Holding Companies Dissolving Committee (*Mochikabugaisha Seiri Inkai*), which was the major shareholder of ex-*zaibatsu* group companies, supported such elections of new directors and officers.²⁴

In 1945, the Labor Union Law was enacted and strengthened the voice of employees. Labor unions were rapidly organized on a company basis. The Companies Reconstruction Law (*Kigyō Saiken Seibi Hō*), a 1947 reform, gave labor unions the right to a voice in the reconstruction plan of each company. Additionally, the government demanded that each company organize the “management discussion board (*keiei kyōgi kai*)” as a place for management and employees to discuss management policy, the accounting situation, and employment policy. On the other hand, the authority of the shareholder meeting was limited and dividend payment was continually restricted.²⁵

Although it is not clear how the company community concept, which is the most important characteristic of the Japanese model,²⁶ was created, it appears as though its origin was in this era. It is plausible that the practice of promoting middle management to director and officer positions, and the *keiei kyōgi kai*, provided the prototype of the company community. It should be noted that this practice may have been harmonious with the existing social norms, such as the egalitarian concept and the preference of human capital providers to monetary capital providers.

The Companies Accounting Emergent Response Law (*Kaisha Keiri Ōkyū Sochi Hō*) of 1946 gave primary control of companies that were damaged by the ending of wartime remuneration to the main bank. Also, the Central Bank of Japan offered loans to companies by forcing banks to organize loan syndicates led by the main bank. In this era, the delegated monitoring system by the main bank was systematized.²⁷

During this period, most companies suffered excessive employment and negative income as a result of the “employee managing

23. Besides the dissolution of *zaibatsu*, the Allies released farm lands to former tenant farmers (*nōchi kaihō*).

24. Okazaki, *supra* n. 11, at 466

25. *Id.*, at 467.

26. See *supra* n. 5 and accompanying text.

27. Okazaki, *supra* n. 11, at 468.

company" corporate governance and the governmental support for inflation policy.²⁸

Another important legal reform in this era, which affected Japanese corporate governance, was the enactment of the Anti-monopoly Law of 1947. The Anti-monopoly Law prohibited the creation of holding companies and restricted the stock holding of financial institutions to five percent at each company.²⁹

These post-war laws, which were mostly initiated by the United States for the purpose of democratizing Japanese economy and society, were strong policy push legislation which literally changed the practice. An interesting thing is that the post-war reforms basically maintained the direction of wartime reforms in regard to the employee-centrism and the main bank monitoring.

C. *Third Era: Growth Oriented Governance*

The third era is from 1949 to 1965. This era is the latter half of the creation era of the Japanese model. This is the period in which rapid Japanese economic growth began. In many ways, this era marked the turnaround of the Japanese system. I will call this period the "era beginning the growth-oriented governance system"³⁰ based on the Company Community" (see Figure 6).

FIGURE 6 III. GROWTH ORIENTED GOVERNANCE

1949	Dodge Line Policies Labor Disputes	Dispersed Stock Ownership Takeover Attempts
1950	Korean War Reform of Commercial Code of Showa 25 Board System Authorized Capital System Minority Shareholder Rights	Corporate Ownership Increasing Delegated Monitoring by Main Bank
1951	San Francisco Peace Treaty	
1954	Asset Revaluation Law	
1955	Joined the United Nations	
1961	"Securities Recession" started	
1964	Japan acceded to the IMF art. 8 Joined OECD Japan Cooperative Securities Co.	
1965	"Yamaichi Crisis" Japan Securities Holding Partnership	

28. *Id.*, at 469.

29. In comparison to the prohibition of owning stock by banks in the United States, Japanese banks are allowed to own the stock of business companies. In comparison to the German system, on the other hand, Japanese banks are prohibited from obtaining control of the firm. This regulation contributed to the creation of the Japanese main bank system.

30. See Okazaki, *supra* n. 11, at 476.

This era started with the so-called Dodge Line policies, which prohibited governmental financial support to companies and pro-inflation policies.³¹ The Dodge Line policies did away with the “employee managing companies.” The loan syndicates led by the main banks forced companies to lay off excessive laborers. From 1949 to 1953, many severe labor disputes occurred. During these disputes, both management and laborers learned that the growth of the company is beneficial to all.³²

As a result of the Dodge Line policies, infant Japanese industries suffered a severe recession that almost killed them. The Korean war, which started in 1950, saved the Japanese economy. Many Japanese industries were revived by the huge military demand.

Stock ownership was dispersed in this era. From 1947 to 1949, government-owned stock had been sold to individuals. In the 1950's, the percentage of individual stock ownership was rather high. It peaked at 69%. Reflecting such a stock ownership structure, the pressure of the capital market was strong. After removing legal restrictions, dividend rates turned high again. Even hostile takeover attempts were made quite often.³³

This process of stock distribution is analogous to the privatization of state-owned firms in Russia and Eastern European countries. In these ex-socialist countries, however, dispersed ownership does not lead to the strong pressure of the capital market, mainly because private ownership is not established.

Also, in the early 1950's, stock ownership by corporations, particularly financial institutions, began increasing (see Figure 7).³⁴ These corporate shareholders sought not only a good return on investments but also long-term business relationships with the invested companies. From the latter point of view, the growth of the companies was the common interest of such corporate shareholders. They also delegated monitoring to the main banks. Thus, the first phenomena of cross shareholding was observed among *ex-zaibatsu* groups companies, which are called *keiretsu*.³⁵

31. Mr. Dodge was an economic adviser to General MacArthur.

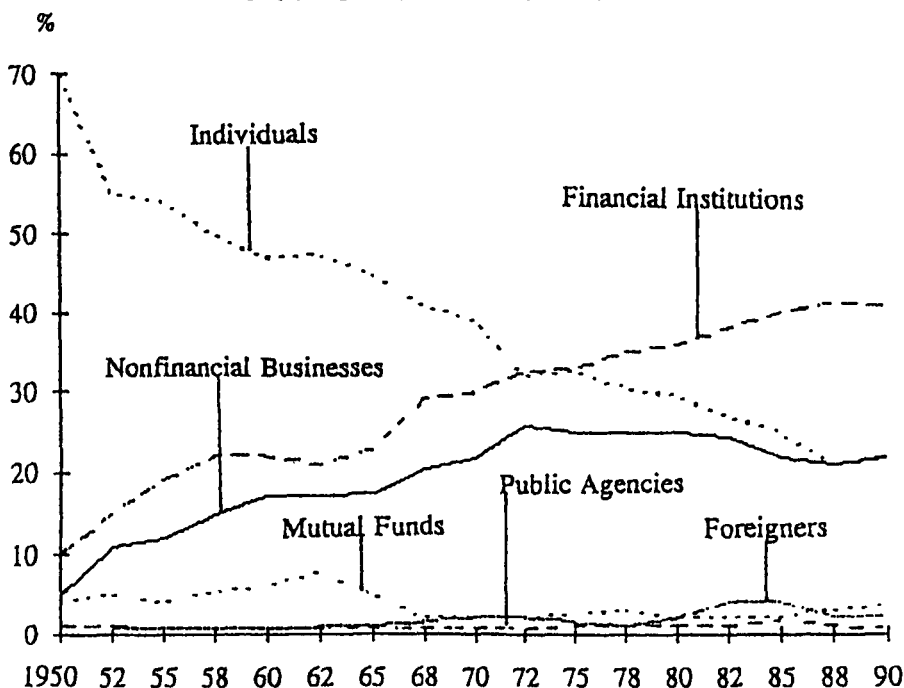
32. Okazaki, *supra* n. 11, at 473.

33. Hideaki Miyajima, “Transformation of Economic System: A Reappraisal of Occupation,” Working Paper No. 99-02, The Institute for Research in Business Administration, Waseda University 16 (1999).

34. Zenichi Shishido, “Institutional Investors and Corporate Governance in Japan,” in Theodor Baums, et al. (eds.), *Institutional Investors and Corporate Governance* 681 (1994). Original data from Zenkoku Shōken Torihikijyo Kyōgikai (National Securities Exchange Markets Roundtable), Kabushiki Bunpu Jyōkyō Chōsa [Research on Stock Distribution].

35. Hidetaka Kawakita, “Kabushikishijyō no Kōzō to sono Henka [The Structure of Equity Markets and its Changes],” 1992-8 *Nissei Kiso Kenkyūjyo Chōsa Gappō* (Japan Life Insurance Basic Research Institute Monthly Research) 3, 7 (1992); Shishido, *supra* n. 34, at 672.

FIGURE 7
STOCK-OWNERSHIP DISTRIBUTION



[Source: Zenkoku Shōken Torihikijyo Kyōgikai (National Securities Exchange Markets Roundtable)]

Such an attempt to stabilize shareholding based on the dispersed ownership is a good example of balancing between monitoring and autonomy of management. The corporate governance practice in the early 1950's showed a dynamic pendulum-like movement.

In 1950, the biggest reform of the Commercial Code regarding corporations was made since its original enactment in 1899—the “external Americanization” of the corporate legal system. The shareholder meeting centered system was changed. The decision-making power of the shareholder meeting was decreased. The board of directors was created and it was given the decision-making power to issue stock. The monitoring power of the auditor was limited to accounting. Under the strong suggestion of the United States, many minority shareholder rights were created. These rights included cumulative voting, appraisal rights, inspection rights of the accounting books, shareholder derivative action, and injunction rights.³⁶

Although this policy push reform changed the characteristics of Japanese corporate law, the impact on the practice was relatively

36. See Kitazawa, *supra* n. 16, at 76; Masafumi Nakahigashi, “Sengo Shōhō no Saishuppatsu [The Restart of the Commercial Code after the War],” 71-7 *Horitsu Jiho* 27 (1999).

moderate. An important point is that giving the board of directors the power to choose financing schemes legally allowed the management certain room to stabilize their position. Particularly, the avoidance of the preemptive right of shareholders gave the management a defensive measure against hostile bids.³⁷ Introducing American-type minority shareholder rights, however, had almost no influence on the practice.

D. Fourth Era: Heyday of Company Community

The fourth period is from 1965 to 1985. These 20 years were the heyday of the Japanese model (see Figure 8). Cross shareholding began to be organized rapidly starting in 1965 and was accomplished in the early 1970's. The Company Communities successfully concentrated the energy of employees into the growth of the companies. The main bank monitoring worked well.

FIGURE 8

IV. HEYDAY OF COMPANY COMMUNITY & MAIN BANK

1965	Yamaichi Crisis Japan Securities Holding Partnership	
1966	Stock Selling by the Two Organizations to "Stable Shareholders"	
1967	Opening Market to Foreign Capital	Reinforcing Cross Shareholding
1969	Public Offering at Market Price Started	Trading Partners as the Stable Shareholders
1971	Regulation on Takeover Bids	Company Community
1974	Reform of Commercial Code of Showa 49	Companyism
1981	Expanding Auditor's Power Reform of Commercial Code of Showa 56	Main Bank Monitoring
1985	Plural Auditors Full Time Auditor Shareholders' Proposal Right Right of Direct-Mail Voting Sokaiya Repellant Bond with Warrants Bubble Economy Starts	

37. Because the provision on the preemptive right of the 1950 reform was ambiguous, two more reforms, in 1955 and 1959, were made on this point. See Michiyo Hamada (ed.), *Nihon Kaisha Rippō no Rekishiteki Tenkai [The Historical Development of Japanese Corporate Law Legislation]* 292, 355 (1999). Although the Commercial Code allows a shareholder to obtain injunction against unfair stock issuing (Commercial Code art. 280-10), Japanese courts are agreeable to management and seldom issue injunction orders. See *In re Kobayashi Department Store Co.*, 493 Hanrei Jiho 53 (Niigata District Ct., Feb. 23, 1967); *In re Takuma Co.*, 1290 Hanrei Jiho 144 (Osaka District Ct., Nov. 18, 1987); *In re Miyairi Barubu Co.*, 1323 Hanrei Jiho 48 (Tokyo District Ct. Sep. 5, 1989).

Cross shareholding had been increasing rapidly after the "securities recession (*shōken fukyō*)" of 1961-1965. Both the banking industry and the securities industry sustained stock market prices by creating two organizations to buy and hold stocks.³⁸ From 1966 through the early 1970's, the stocks owned by the two organizations were sold to banks, life insurance companies and nonfinancial businesses which did business with the issuing companies.³⁹ In this period, liberalization of the market for foreign capital provided incentives to stabilize shareholding.⁴⁰

At the end of 1964, the Japanese economy suffered severely from the recession and many big companies went bankrupt, revealing their fraudulent accounting. The reform of the Commercial Code of 1974, which responded to such events, tried to build an effective monitoring system to prevent management from engaging in illegal activities. The auditor's monitoring power, which had been limited to accounting in 1950, was again expanded to monitoring illegality in general. The earlier capital-market legal requirement of certified audits was extended to all large companies.

The reform of the Commercial Code of 1981 again reinforced the auditor system. Big companies were required to have more than two auditors, one of which was full time. This reform also strengthened shareholder rights relating to the shareholder meetings, such as the shareholders' proposal right and the right of voting by mail. The reform also prohibited giving benefits to specific shareholders, thus precluding professional shareholders (*sōkaiya*).⁴¹

Most of these reforms were policy push reforms, except the enactment of bonds with warrants in 1981. The major point of these two reforms was to strengthen the monitoring power of auditors. The auditor has, however, never been an effective monitor. In that sense, these reforms had little effect on the practice. The reforms of the auditor system were legislative responses to the scandals of large companies during the recession and they were acceptable to the company communities. The company communities would not have accepted a reform of the board because the board of directors had already been

38. Japan Cooperative Securities Co. (*Nihon Kyodo Shoken*) was created by the banking industries in 1964 and Japan Securities Holding Partnership (*Nihon Shoken Hōyū Kumiai*) was created by the securities industry in 1965.

39. Kawakita, *supra* n. 35, at 14-17; Shishido, *supra* n. 34, at 673.

40. In 1964, Japan acceded to the International Monetary Fund's (IMF) article 8, which prohibits exchange restrictions, and joined the Organization for Economic Cooperation and Development (OECD), which in principle prohibits restrictions on direct foreign investment. The Japanese Government gradually opened the market for foreign capital from 1967 to 1975. See Shishido, *supra* n. 34 at 673.

41. Although the number of *sōkaiya* decreased after this regulation, the relationship between *sōkaiya* and Japanese firms has not yet been wiped out. See e.g., Nikkei, Nov. 9, 1999 (night version) pp. 1, 18, 19 on the Kobe Steel Case. See generally West, "Information, Institutions, and Extortion in Japan and the United States: Making Sense of Sokaiya Racketeers," 93 *NW. L. Rev.* 767 (1999).

deeply implemented in the company community. The plural auditor system, however, simply provided the members of the company community another post.

E. Fifth Era: Transition

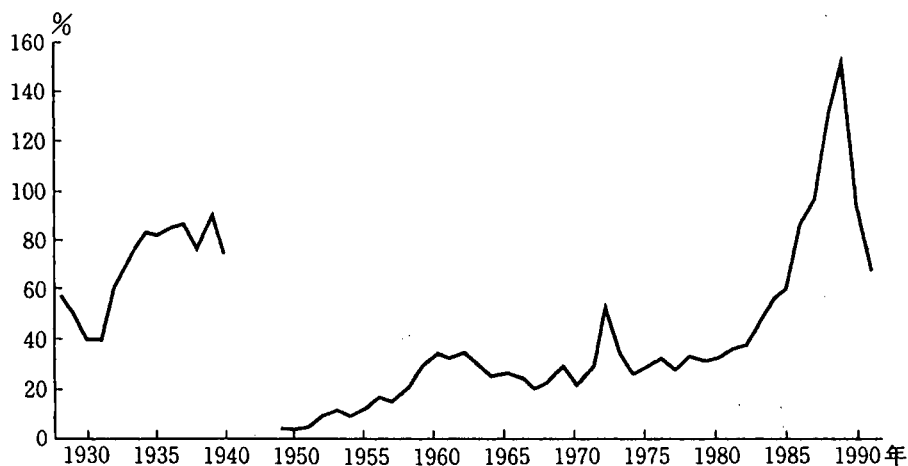
The fifth era is from 1985 to the present. This is the era of bubble economic growth and recession after the bubble burst. I will call this period the “era of governance imperfection post-economic growth and internal Americanization” (see Figure 9).

FIGURE 9 V. POST ECONOMIC GROWTH GOVERNANCE IMPERFECTION & TRANSITION

1985	Bubble Economy Starts Capital Adequacy Requirements by BIS	Waste of Free Cash Flow
1990	Burst of Bubble, Starting of a Long Recession	Selling Off by Stable Shareholders
	Reform of Commercial Code of Heisei 2 Minimum Capital Increasing Upper Limit of Bond	Retreat of Main Bank Increase of Straight Bonds Issuing
1993	Reform of Commercial Code of Heisei 5 Abolishing Upper Limit of Bond Bond Managing Company Board of Auditors Outside Auditor Decreasing Filing Fee of Shareholder Derivative Action Inspection Right of Accounting Books Opened to 3% Shareholders	
1994	Reform of Commercial Code of Heisei 6 Deregulation of Stock Buybacks	
1997	Reform of Commercial Code of Heisei 9 Stock Redemption by Profit Stock Options Short Form Mergers Strengthening <i>Sōkeiya</i> Repellent Reform of Anti-monopoly Law Allowing Holding Companies	Bank Reluctance to Lend Money Destruction of Lifetime Employment
	Bankruptcy of Yamaichi	Strong Pressure of Capital Market Internal Americanization(?)
1998	Allowing Revaluation of Real Estates Deregulation of Stock Investment by Pension Funds	
1999	Reform of Commercial Code of Heisei 11 Share-Exchange Acquisition	
2000	Reform of Commercial Code of Heisei 12 Spin Off	
2001	Reform of Commercial Code of Heisei 13 Deregulation of Stock Options Class Voting Tracking Stock	

In the 1980's, Japanese economic growth slowed down. In 1985, the bubble emerged and until it burst at the end of 1989, the Nikkei Dow almost tripled (see Figure 10).⁴² Japanese management enjoyed free cash flow for the first time in history and they wasted it.⁴³ Japanese corporate governance was good at encouraging the growth of the company but had never experienced the need to monitor for efficient use of free cash flow.

FIGURE 10
THE AGGREGATE PRICE OF LISTED STOCKS/GNP



[Source: Okazaki, *supra* n. 11]

In the 1990's, after the bubble burst, the Japanese economy suffered a long recession. Japanese corporate governance was forced to change. The 1990s were the transition era of Japanese corporate governance.

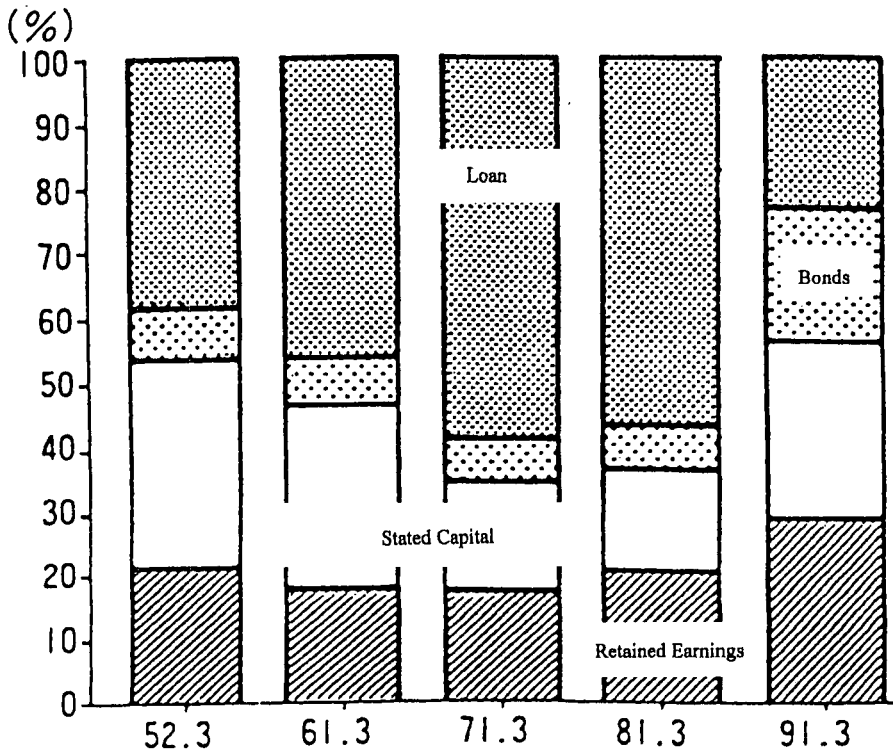
The first important change was the retreat of the main bank. The source of corporate financing had been shifting from bank loan to equity and straight bond financing. Bank loans are no longer a dominant source of financing to Japanese companies (see Figure 11).⁴⁴ Thus, banks have lost their bargaining power, which supported their monitoring function. Additionally, the financial crisis, which began in 1997, made banks reluctant to lend money and ended their ability to rescue failing client companies.

42. Okazaki, *supra* n. 11, at 440.

43. See Shigeru Watanabe & Isao Yamamoto, "Nihon Kigyō no Kōporēto Gabanansu: Sengo Saitei no ROE kara [The Corporate Governance of Japanese Firms: The Lowest ROE after the War]," 1992-9 *Zaikai Kansoku* (Business World Observer) 2, 11.

44. *Id.* at 12.

FIGURE 11
SOURCES OF CORPORATE FINANCING (MANUFACTURING)



[Source: Watanabe & Yamamoto, *supra* n. 43]

The second change is the decrease of the cross shareholding rate and the stable shareholding rate. From 1990 to 1998, the former decreased more than 3 percent and the latter decreased more than 7.5 percent (see Figure 12).⁴⁵ Cross shareholding partners and stable shareholders began to sell off their partners' stock when the stock investment return became lower than the long-term prime rate in 1990 (see Figure 13).⁴⁶

45. Statistics by Nissei Kiso Kenkyūjyo (Japan Life Insurance Basic Research Institute) (1999).

46. Keiichi Omura, Atsushi Uno, Hidetaka Kawakita, & Masashi Toshino, *Kabushiki Shijyō no Maikuro Sutorakuchā (The Micro Structure of the Securities Market)* 221 (1998).

FIGURE 12

Cross Shareholding Rate & Stable Ownership Rate of the Stock Market (%)					Cross Shareholding Rate & Stable Ownership Rate of the Stock Market (Changes) (%)				
Money Base		Number of Stock Base			Money Base		Number of Stock Base		
Year	Stabilizing Rate	Crossholding Rate	Stabilizing Rate	Crossholding Rate	Year	Stabilizing Rate	Crossholding Rate	Stabilizing Rate	Crossholding Rate
1986	48.91	21.93	45.97	18.26	1986				
1987	47.84	21.47	45.16	18.11	1987	▲ 1.07	▲ 0.46	▲ 0.81	▲ 0.15
1988	47.69	21.00	45.38	17.97	1988	▲ 0.15	▲ 0.47	▲ 0.22	▲ 0.14
1989	46.77	20.30	45.29	17.79	1989	▲ 0.92	▲ 0.70	▲ 0.09	▲ 0.18
1990	47.52	21.42	45.75	18.62	1990	0.75	1.12	0.46	0.83
1991	47.45	21.32	45.41	18.60	1991	▲ 0.07	▲ 0.10	▲ 0.34	▲ 0.02
1992	47.57	21.21	45.17	18.39	1992	0.12	▲ 0.11	▲ 0.24	▲ 0.21
1993	46.98	20.77	44.15	17.96	1993	▲ 0.59	▲ 0.44	▲ 1.02	▲ 0.43
1994	46.68	20.70	43.42	17.67	1994	▲ 0.30	▲ 0.07	▲ 0.73	▲ 0.29
1995	45.14	20.31	41.79	17.16	1995	▲ 1.54	▲ 0.39	▲ 1.63	▲ 0.51
1996	43.73	19.52	41.17	17.10	1996	▲ 1.41	▲ 0.79	▲ 0.62	▲ 0.06
1997	42.04	18.19	39.59	16.41	1997	▲ 1.69	▲ 1.33	▲ 1.58	▲ 0.69
1998	41.26	16.02	38.22	15.39	1998	▲ 0.78	▲ 2.17	▲ 1.37	▲ 1.02

Statistics by Nissei Kiso Kenkyūjyo (Japan Life Insurance Basic Research Institute) (1999).

FIGURE 13
RETURN ON INVESTMENT IN STOCK



[Source: Omura et al, supra n. 46]

Not only has cross shareholding decreased in general, but the capital market has also been selecting good companies and bad companies. The difference in the aggregate price of all issuing stocks from the top 10 percent and bottom 10 percent of the Tokyo Stock Ex-

change first listing companies expanded from 68 times at the end of 1989 to 300 times in September 1999.⁴⁷

The stock market quickly responds to restructuring plans of issuing companies. Generally speaking, stock prices will rise after the release of drastic layoff plans. Not a small number of presidents were forced to resign because of poor stock price. Stockholding by foreign institutional investors increased and they have continued to use their voice as in their home countries. The number of shareholder derivative actions also increased after the legal reform in 1993.⁴⁸ Japanese individual shareholders became sensitive to their rights as shareholders.

Overall, the presence of shareholders, which used to be hidden, was revealed in the 1990's. They began to use their direct monitoring power either by exit or by voice.

The third and maybe the most important change is the destruction of lifetime employment.⁴⁹ Employees began to feel that the implicit promise of lifetime employment had been breached or would be breached. These feelings became particularly strong after 1997, when some big companies, including Yamaichi Securities Firm, went bankrupt, and responding to the pressure of capital markets, many big companies were forced to lay off employees. Lifetime employment was one of the main premises of the Company Community. The destruction of lifetime employment will inevitably change the concept of the Company Community. Actually, each Japanese company is now struggling to find a new direction of corporate governance, whether abandoning the community concept completely or keeping its benefits in some ways.

These three major changes in Japanese corporate governance practice were initiated by the changing background economic market. Those social norms that no longer were in harmony with the background economic market had to change. In other words, such a balancing mechanism is the strength of Japanese economy.

In the 1990's, the Commercial Code was frequently reformed. The characteristic of the legal reforms of the 1990's is that most of them were caused by the pressure of business people and they had

47. Nikkei, Oct. 27, 1999, p. 1.

48. According to the Supreme Court, the number of pending cases of shareholder derivative actions at all district courts and appellate courts in Japan was 84 in the end of 1993, when the reform was enacted, increased to 133 in the end of 1994, and 174 in the end of 1995. See Zenichi Shishido, "Heisagaisha to Kabunushi Daihyōsoshō (Shareholder Derivative Actions in Closely Held Corporations)," in Hideyuki Kobayashi & Mitsuo Kondo (eds.), *Kabunushi Daihyōsoshō Taikei (The Structure of the Shareholder Derivative Action)* 36 (1996).

49. Professors Gilson and Roe point out the relationship between lifetime employment and the lack of an external labor market in Japan. See Gilson & Roe, "Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance," 99 *Colum. L. Rev.* 508 (1999).

quick and direct influence on corporate governance practice. In that sense, they are demand pull reforms.

In 1990 and 1993, bond issuing was deregulated. The issuing of straight bonds dramatically increased after these legal reforms. Such a diversity of debt selection and the decline of the main bank system are causes and results of each other. The deregulation of stock buybacks in 1994 and, particularly, the allowing of redemption by profit in 1997, has given management a way of returning free cash flow to the shareholders.⁵⁰ In 1997, the stock option was also permitted and many companies adopted it soon after the enactment.⁵¹ Creation of the holding company, which had been prohibited by the Antimonopoly Law since 1947, was allowed in the same year. Many companies declared their plan of adopting the holding company system. I think that the adoption of stock options and holding companies, both legally and practically, reflects the changes in the Company Community. In 1998, deregulation of stock investment by pension funds, which will have a huge potential effect on corporate governance, was effected. In 1999, the share exchange as a mechanism to make a wholly owned subsidiary was introduced, which makes both the creation of holding companies and mergers-and-acquisitions easy.

Decreasing the filing fee of shareholder derivative actions in 1993 was not a demand pull reform, but a traditional policy push reform on the Commercial Code. For a policy push reform, it had an unusual effect on practice. The number of derivative actions drastically increased after the reform. In the past, such a phenomenon has had a significant effect on corporate governance. Although other policy push reforms, such as requiring the board of auditors and an outside auditor for large companies,⁵² and decreasing the minimum stock owning requirement for the inspection right of accounting books were also made in 1993, they have had almost no effect on practice so far.

In the 1990's, the mandatory nature of Japanese corporate law was partly changed by the demand pull reforms. Mandatory laws

50. See Shōji Hōmu (Commercial Law Center), "Zōshi Hakusho (Capital Increase Report)," 1530 *Shōji Hōmu* 129 (1999).

51. See Chuo Coopers & Lybrand Advisors Co., Ltd., *Sutokku Opushon Jitsumu Handobukku [Practical Handbook on Stock Options]* 372 (1999).

52. The outside auditor must not have been either a director, a manager, or an employee of the company and its subsidiaries in the last five years (Audit Special Exception Law art. 18). Most outside directors were ex-directors or ex-employees who returned more than five years after their retirement. Real outside auditors, who had never belonged to the company community, were very rare. Just since 2002, at least half of auditors are now required to be outside directors, i.e., individuals who have never been directors, managers, nor employees of the company or its subsidiaries.

prohibiting demand practices have been individually changed into enabling law.⁵³ I call such phenomenon “internal Americanization.”

IV. U.S. RELATIONSHIP BETWEEN LEGAL REFORMS AND CORPORATE GOVERNANCE

The characteristics of corporate governance practice arise from solutions to the two hidden problems of corporate law. These solutions have historically depended on many factors, in particular, background economic markets, social norms, and legal systems. The legal system does not define corporate governance practice. Rather, it is only one factor. We can observe some legal systems that gave direction to the practice. But we can also observe some cases in which the pressure from the practice changed the legal system.

We have examined the relationship between legal reforms and corporate governance practice over 100 years by using the analytical framework of policy push reform and demand pull reform. The demand pull reforms are, by definition, expected to be immediately used in practice. Therefore, most demand pull reforms affected practice, but they were causes and results of each other. On the other hand, the policy push reforms which influenced practice are relatively rare.

The legal reforms which were the most influential to corporate governance practice are the series of special laws enacted during the war and the occupation period. These typical theory push reforms, which combined the background economic market and Japanese social norms,⁵⁴ gave the direction to the Japanese model. Some other legal reforms from this period, such as the enactment of the Labor Union Law,⁵⁵ the prohibition of the holding company and the stockholding restriction placed on banks by the Anti-monopoly Law also greatly influenced practice.⁵⁶

53. This trend has been continuing in the new century. In 2000, the spin-off was permitted. In 2001, most restrictions on the stock option were taken off and the class voting and the tracking stock were permitted.

54. Japanese social norms which have affected corporate governance practice are, for example, egalitarianism, preference of human capital providers to monetary capital providers, valuing long-term relationships, and humanizing corporations.

55. Not only statutory labor laws, but also labor case laws have had significant influence on corporate governance practice. Particularly, the case law doctrine of the “abused dismissal” has supported lifetime employment. See *In re Kochi Hōso*, 268 Rōhan 17 (Sup. Ct. Jan. 31, 1977); *In re Toyo Sanso*, 30 Rōminshu 1002 (Oct. 29, 1979); Chih-Poung Liou, “Nihon Rōdōhō ni okeru Kaikoken Ranyō Hōri no Keisei: Sengo kara Showa 35 Nen madeno Saibanrei wo Chūshin to shite (The Doctrine of Abused Dismissal in Japanese Labor Law: Cases from the End of the War until Showa 35),” Working Paper, Japan International Labor Law Forum Special Series No. 5 (1999).

56. Without these regulations, the relationship among firms named *keiretsu* and the role of main banks would have been different.

On the other hand, the two flag issues of many post-war reforms of corporate law—the strengthening of minority shareholders' rights⁵⁷ and the strengthening of the auditor system, which are typical theory push reforms—appear to have had almost no influence on the practice of corporate governance. These reforms gave neither shareholders and management the incentive to use them, nor had the power of direct regulations as in the wartime legislation.

An exceptional policy push reform, which affected the practice, was the decrease in filing fees of the shareholder derivative action in 1993. This reform had a huge announcement effect and stimulated the incentive of shareholders to sue directors during the circumstance of “post economic growth governance imperfection.” With this reform, Japanese management became reluctant to balancing stakeholders' interests.⁵⁸

The characteristic of legal reforms of the 1990's is that there are many demand pull reforms, which had immediate influence on the practice. This phenomenon reflects the transition of the Japanese corporate governance.

V. CONCLUSION

When we glance back through the history of Japanese corporate governance, we find pendulum-like movements between the relative power of shareholders and employees (see Figure 14).

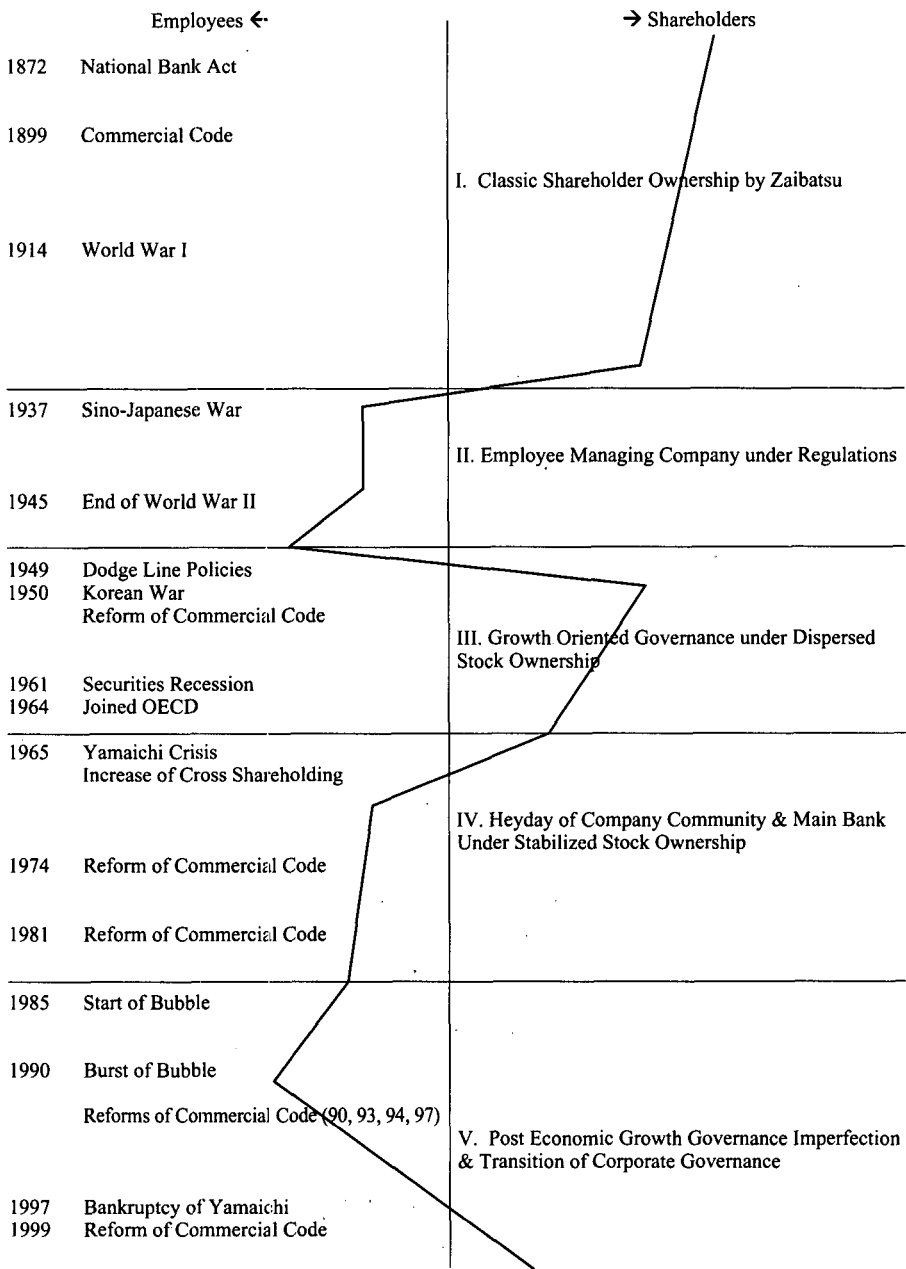
During the first era of classic shareholder ownership by the *zaibatsu* families, shareholders' power was overwhelming. But, as a result of the *zaibatsu*'s policies aimed at increasing employee retention, employees were able to gradually increase their power.

During the second era of the “employee managing company” under governmental regulations, shareholder power was restricted by wartime laws, which simultaneously increased employee power. Even after the war, during the occupation period, the trend of increasing employee power continued. The government encouraged employee participation in management. The inefficient “employee management company” was sustained by governmental subsidies.

57. I am skeptical about the argument that the strength of minority shareholders' rights is significantly related to the degree of dispersed ownership and corporate governance practice. See Rafael La Porta, et al., “Legal Determinants of External Finance,” 52 *J. Fin.* 1131 (1997). The establishment of shareholder ownership as the end-game norm, in other words, the establishment of private property ownership, looks more important.

58. In the bankruptcy of Yamaichi, for example, Fuji Bank, the main bank of Yamaichi, was reported to have refused to rescue Yamaichi because of the fear of shareholder derivative action. See *Nikkei*, Dec. 2, 1999 (evening version) p. 5.

FIGURE 14
THE RELATIVE POWER OF SHAREHOLDERS AND EMPLOYEES



During the third era of growth-oriented governance under dispersed stock ownership, the pressure of the stock market dramatically increased after subsidies were abolished. In order to guard

against hostile takeover attempts, management initiated cross shareholding.

During the fourth era of the Company Community and the main bank, stock ownership was stabilized and the power of employees became so strong it was deemed "employeeism."

During the fifth era of the bubble economy, the power of employees grew even stronger. The Company Community enjoyed free cash flows which alleviated its need to seek external funds, thus further increasing its autonomy. After the bubble burst and a long recession began, the power of shareholders dramatically increased again.

The balance between shareholder monitoring and the autonomy of management has had similar movements (see Figure 15). However, as a result of the existence of monitors other than shareholders, these fluctuations have generally been less severe. Particularly during the fourth era, the heyday of the Japanese model, a good balance was achieved. The balance was destroyed after the bubble emerged, when even main bank monitoring was ineffective. The fluctuations during the fifth era were drastic, and similar movement can be observed during the second era.

There were four drastic shifts in power. The first two changes, which occurred between the first and second eras and the second and third eras, were both policy push changes. On the other hand, the third change between the third era and the fourth era, and the fourth change during the fifth era were both demand pull changes.

The corporate legal systems of the United States and Japan are quite similar, yet we can observe big differences in the practice of corporate governance. It appears as though the effect of the legal system on corporate governance practice is not great. When we observe the history of legal reforms, however, we can see how the legal system has played an important role in creating corporate governance practice.

The actual effect of legal reform on the practice depends on the coordination of practical demands, which is the creature of the background economic market and social norms. The demand pull reforms, which are the result of practical demands, mostly have immediate influence on the practice. The influential policy push reforms, on the other hand, either have the power of direct regulation or successfully stimulate the practical demands.

FIGURE 15
THE BALANCE BETWEEN MONITORING AND AUTONOMY
OF MANAGEMENT

