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REFORMING THE JAPANESE COMMERCIAL CODE: A STEP TOWARDS AN AMERICAN-STYLE EXECUTIVE OFFICER SYSTEM IN JAPAN?

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Abstract: After more than a decade of attempting to remedy failing banks, rising unemployment, and a shrinking economy, Japan has taken a new approach to economic reform. With the hope of improving corporate profits and international competitiveness, the Japanese Diet passed legislation in May 2002 amending the Commercial Code to allow corporations to adopt an American-style executive officer system. The amendment establishes a workable new framework for more effective corporate governance in Japan and serves as an important early step in what promises to be a long road to reform. These benefits notwithstanding, its impact will be limited by the Amendment's optional nature, a preference for Japanese business practices, the persistence of weak, insider-dominated boards of directors, and renewed suspicion of American corporate institutions following the wave of American corporate scandals.

I. INTRODUCTION

After suffering from a moribund economy for more than a decade,¹ Japan is desperate to escape its decade-long recession and restore corporate earnings.² Japan's inability to recover from this prolonged economic slowdown has led its business and political leaders to seek creative solutions for reform of business practices on many levels.³ However, efforts by leaders in Tokyo to revive the economy by cutting interest rates, funding massive public works projects, and instituting schemes to spur consumer spending have all come up short.⁴ Moreover, "Big Bang"⁵ reforms in

¹ The author would like to thank Professor Richard Kummert for his assistance and guidance on this project and the *Pacific Rim Law & Policy Journal* Editorial Staff for all of their time and effort. The author would also like to thank Tomoko Miyao for her support and patience throughout the writing process.

² Japan External Trade Organization, *New Business Practices and Opportunities in the Japanese Economy* (Oct. 10, 2002), at http://www.jetro.go.jp/it/e/pub/biz_practices2002/gce2.html (last visited Jan. 28, 2003) [hereinafter *New Business Practices*].

³ See Takashi Narusawa et al., *Rebirth of Japanese Companies Through Governance Reforms*, Nomura Research Institute 2 (Apr. 1, 2001), at <http://www.nri.co.jp/english/report/papers/2001/pdf/np200125.pdf> (last visited Feb. 24, 2003).

⁴ See, e.g., Marc Goldstein, *A Rude Awakening in Japan*, *ASIAN WALL ST. J.*, Aug. 21, 2002, at A7; Carla Rapoport, CFO, MAG. FOR SENIOR FIN. EXECUTIVES, July 1, 2002, at 1 (indicating a ten-year decline in shareholder value).

⁵ Mark Poe et al., *Revising the Japanese Commercial Code: A Summary and Evaluation of the Reform Effort*, 2 *STAN. J. E. ASIAN AFF.* 71 (2002).

⁶ This program of economic reform was announced by then-Prime Minister Ryutaro Hashimoto in 1997 and focuses on wide ranging reforms in key industries. *Id.* at 71 n.5. The program takes its name from a 1986 British financial reform package which moderately stimulated the British economy. *Id.*

industries such as banking, capital markets, and insurance⁶ have largely failed to turn the economy around.⁷

Many business and political leaders on both sides of the Pacific argue that Japan's stagnant and scandal-ridden⁸ economy is due in large part to its poor corporate governance practices.⁹ Bloated, insider-dominated boards of directors¹⁰ and ineffective corporate auditors are part of a corporate governance scheme that fails to deliver accountability and profit to shareholders in an increasingly competitive global economy.¹¹ If Japan's corporate governance practices are a source of its economic woes, the Diet's¹² May 2002 amendment ("Amendment") to the Commercial Code¹³ ("Code"), providing Japanese corporations with the option to adopt an American-style executive officer system, may provide a framework for a more efficient and reliable system of corporate governance.¹⁴ For legal and cultural reasons, however, the Amendment alone will likely not create systemic reform. The Amendment's optional nature, strong preference for Japanese business practices, the persistence of certain cultural norms, and renewed suspicion of American corporate institutions following the recent wave of corporate scandals threaten to limit its overall effectiveness.

This Comment analyzes the Amendment's potential impact on Japan's conventional corporate governance practices and argues that, although it is

⁶ *Id.* at 71.

⁷ See World Economic Forum, *How in the World Can Japan Compete? Revamping the Japanese Model* (Jan. 28, 2000), at <http://www.weforum.org/site/knowledgenavigator.nsf/Content/How%20in%20the%20world%20can%20Japan%20compete%3F%20Revamping%20the%20Japanese%20model> (last updated Dec. 26, 2002) (quoting Kenneth S. Curtis, Vice Chairman of Goldman Sachs Asia at the 2000 annual meeting of the World Economic Forum as saying that Japan remains "trapped in the vicious jaw of debt, deflation and demographics").

⁸ See, e.g., Goldstein, *supra* note 3, at A7 (discussing scandals in Japan's "insular food processing industry" and linking those failures to poor corporate governance); Rapoport, *supra* note 3, at 1 (indicating a ten-year decline in shareholder value).

⁹ See, e.g., Reiji Yoshida, *Japan Gropes for Ideal Corporate Governance Model*, JAPAN TIMES, Aug. 23, 2002, at 1, available at LEXIS, Asia/Pacific Rim, Current News File.

¹⁰ *Corporate Officer System Should Shake Up Complacent Boards*, NIKKEI WKLY., Mar. 15, 1999, at 18.

¹¹ See Holly J. Gregory, *The Globalization of Corporate Governance*, Weil, Gotshal & Manges LLP, at http://ruworldbank.org/documents/the_globalization_of_corporategovernance.pdf (Jan. 13, 2002).

¹² The Diet is Japan's national legislature.

¹³ The Japanese Commercial Code (*Shōhō*) provides for the incorporation of public stock corporations (*kabushiki-kaisha*) and contains the basic laws governing their conduct. See generally SHŌHŌ [Commercial Code] (Japan). The original version of the Code was adopted at the close of the nineteenth century. Yoshiro Miwa, *Corporate Social Responsibility: Dangerous and Harmful Though Maybe Not Irrelevant*, 84 CORNELL L. REV. 1227, 1230 (1999). However, after World War II the Code was revised under a strong American influence. *Id.*; see also Mark D. West, *The Puzzling Divergence of Corporate Law; Evidence and Explanations from Japan and the United States*, 150 U. PA. L. REV. 527, 528-29 (2001) (indicating that the Illinois Business Corporation Act was a particularly influential force during the Code's post-war revision).

¹⁴ See Poe et al., *supra* note 4, at 75.

an important step in creating substantive change in the way Japanese firms are governed, a number of obstacles will limit its positive effects. Part II identifies the principal-agent dilemma as the primary problem American-style corporate governance seeks to address and analyzes how the executive officer system is designed to limit its negative consequences. Part III examines conventional Japanese corporate governance practices and then briefly addresses some recent economic changes that expose them as increasingly ineffective. Part IV surveys the Amendment's statutory framework and Part V argues that while the Amendment serves as an important step towards creating corporate governance reform in Japan, several legal and cultural factors will severely limit its positive effects.

II. THE AMERICAN PARADIGM: PRINCIPAL-AGENT PROBLEMS AND SOLUTIONS

In order to understand the impact that adopting an American-style executive officer system may have on Japanese corporations, one must understand both the problem the system is intended to address and how it is designed to do so.¹⁵ American corporate law is primarily concerned with limiting the harmful effects arising out of the asymmetry between shareholder and executive interests.¹⁶ The executive officer system is a key part of a system of structural checks intended to minimize those harmful effects.

A. *American Corporate Governance Seeks to Limit the Adverse Effects of the Principal-Agent Model*

The principal-agent relationship arising out of the separation of corporate control¹⁷ from its ownership¹⁸ has long been identified as the

¹⁵ Since the focus of this Part is on how American corporations are intended to operate, it relies on the provisions of the American Law Institute's ("ALI's") PRINCIPLES OF CORPORATE GOVERNANCE, rather than specific state corporation law. The PRINCIPLES are the product of the ALI's attempt to both restate and recommend changes to the operation of American business corporations. PRINCIPLES OF CORPORATE GOVERNANCE, President's Forward, at 6 (1992) [hereinafter PRINCIPLES].

¹⁶ Kevin Keasey et al., *Introduction: The Corporate Governance Problem—Competing Diagnoses and Solutions*, in CORPORATE GOVERNANCE 1-2 (Kevin Keasey et al. eds., 1997).

¹⁷ For the purposes of this Comment, the term "corporate control" refers to the active executive management of the corporation, including:

- (a) the chief executive, operating, financial, legal, and accounting officers of a corporation;
- (b) to the extent not encompassed by the foregoing, the chairman of the board of directors (unless the chairman neither performs a policymaking function other than as a director nor receives a material amount of compensation in excess of director's

primary source of executive misconduct¹⁹ and the focus of American corporate governance.²⁰ Analysis of the nature of the corporate entity illustrates the problem. At its core, a public corporation is governed by a multilayered relationship between shareholders, directors and executives.²¹ The shareholders surrender the day-to-day management of the corporation to executives who have the business expertise to manage it.²² In turn, the executives agree to run the corporation in the owners' interests by earning a corporate profit and delivering shareholder gain.²³ In order to ensure their interests are addressed, shareholders elect a board of directors, which independently and collegially oversees²⁴ the executives and sets broad corporate policy.²⁵ This relationship between the shareholders who want a job done and the executives who are willing to do it is known as a principal-agent relationship.²⁶

When managers use their expertise to benefit shareholders, the system works well, but it is not difficult to imagine how shareholder and executive interests can diverge. Executives and others in control of the corporation might be tempted to exploit their positions and engage in self-dealing

fees), president, treasurer, and secretary, and a vice-president or vice-chairman who is in charge of a principal business unit, division, or function (such as sales, administration, or finance) or performs a major policymaking function for the corporation; and (c) any other individual designated by the corporation as an officer.

PRINCIPLES, *supra* note 15, § 1.27.

¹⁸ For the purposes of this Comment, the corporation's ownership refers to its shareholders.

¹⁹ Keasey et al., *supra* note 16, at 1-2.

²⁰ Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract Culture and the Rule of Law*, 37 HARV. INT'L L.J. 3, 18-19 (1996) [hereinafter Milhaupt, *Relational Theory*].

²¹ Corporate governance may be defined broadly as the systems that govern a corporation's behavior, including all of the formal and informal relationships surrounding the corporate sector as well as their consequences for society in general. See Keasey et al., *supra* 16, at 1-2. In a narrower sense, the term may simply refer to the formal systems that ensure management accountability to shareholders. See *Id.* For the purposes of this Comment, the term corporate governance shall refer to the latter definition, but will also make reference to some of the cultural norms that bear on the application of those structures.

²² MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS, CASES AND MATERIALS 147 (8th ed. 2000); PRINCIPLES *supra* note 15, § 3.02 cmts. a, d (indicating that although most state business statutes literally seem to require the board to directly manage the company, it is "widely understood that the board of a publicly held corporation normally cannot and does not perform those functions in the usual sense of those terms;" rather, it operates more as a collegial oversight body with respect to the officers).

²³ PRINCIPLES, *supra* note 15, § 2.01(a).

²⁴ The board's oversight function is not usually carried out directly by actively supervising the principal senior executives, but rather indirectly by evaluating the performance of those executives and taking actions to replace those officers that fail to meet reasonable job performance expectations. See PRINCIPLES, *supra* note 15, § 3.02 cmt. d.

²⁵ See PRINCIPLES, *supra* note 15, § 3.01 cmts. a-c.

²⁶ RESTATEMENT (SECOND) OF AGENCY § 1 (1958); Keasey et al., *supra* note 16, at 3 (indicating that this conception of the corporation serves as the dominant American paradigm).

transactions that benefit themselves, rather than shareholders.²⁷ Limiting these so-called agency costs in an attempt to ensure the accountability of management to shareholders is the primary policy behind United States corporate- and securities-related laws.²⁸

B. The Executive Officer System: Maximizing Accountability and Efficiency in the Principal-Agent Paradigm

Together with several other control mechanisms,²⁹ the executive officer system³⁰ is one of the fundamental features of modern American corporate governance.³¹ Executive officers are a corporate organ separate from the board of directors³² and are delegated authority by the board to carry out the corporation's day-to-day business.³³ As such, officers can be removed by directors³⁴ and are subject to the board's general oversight and business policy objectives.³⁵ Officers are therefore subordinate to and independent of the board of directors.³⁶ As a result of this separation, the board is able to objectively and collegially oversee the executives in the interests of shareholders.³⁷ Additionally, the system facilitates more

²⁷ Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 49 AM. J. COMP. L., 317, 329-330 (1998).

²⁸ Michael Bradley et al., *Challenges to Corporate Governance: The Purposes and Accountability of The Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9, 57 (1999); Milhaupt, *supra* note 20, at 18-19.

²⁹ This Comment does not attempt to catalogue the myriad ways that corporations can and are governed. Rather, this Comment briefly addresses some of the major methods of American corporate governance mechanisms in order to demonstrate that the executive officer system does not simply act alone. See Alistair Bruce & Trevor Buck, *Executive Reward and Corporate Governance*, in CORPORATE GOVERNANCE 80-82 (Kevin Keasey et al. eds., 1997) (indicating that each of the various control methods reflects the underlying tension of the principal-agent relationship).

³⁰ The executive officer system may be characterized as a direct control mechanism. See Brad Glosserman, *Progress or Perish: Just Say Yes To Corporate Governance*, THE JOURNAL, American Chamber of Commerce Japan, at 2 (Nov. 2000), at <http://www.accj.or.jp/lib/docs/00.11.progress.orperish.pdf> (last visited Feb. 24, 2003). These corporate governance mechanisms refer to the oversight and interventional functions of parties that have vested interests in the corporation. See *Id.* Also, they rely heavily on the autonomy and independence of the corporation's constituent organs. See Mary E. Kissane, *Global Gadflies: Applications and Implications of U.S.-Style Corporate Governance Abroad*, 17 N.Y.L. SCH. J. INT'L COMP. L. 621, 626 (1997).

³¹ See Kissane, *supra* note 30, at 626.

³² Compare PRINCIPLES, *supra* note 15, § 3.01 with PRINCIPLES, *supra* note 15, § 3.02.

³³ See PRINCIPLES, *supra* note 15, § 3.01.

³⁴ See *id.* § 3.02(a).

³⁵ See *id.* § 3.02(b).

³⁶ Misao Tatsuta & Richard O. Kummert, *Japanese and U.S. Business Corporation Law Vol. I*, 5-17 (1996) (unpublished course materials) (on file with the University of Washington School of Law).

³⁷ See PRINCIPLES, *supra* note 15, § 3.02 cmt. d. The effectiveness of this separation has been called into question in the wake of the Enron collapse and other recent corporate scandals in America. See, e.g.

efficient decision-making because officers are free to make operational decisions without being forced to consult another layer of authority.³⁸ Given the distinct roles granted to the executive officers and board of directors,³⁹ these two corporate organs must be implemented together in order to reap their operational and oversight benefits.⁴⁰

Indirect control mechanisms⁴¹ such as the stock market and the possibility of takeover supplement the direct controls⁴² afforded by the executive officer system.⁴³ The liquidity of American stock markets⁴⁴ enables investors to easily allocate their capital to corporations that provide the best risk-adjusted returns.⁴⁵ Since a corporation's share price theoretically reflects the performance of executive management, rational shareholders will demand a change in strategy, sell their interests or attempt to remove executive management when profits fall.⁴⁶ Similarly, the threat of a leveraged buy-out or other takeover measure indirectly creates incentives for corporate executives to maximize corporate performance or face being ousted.⁴⁷

Another increasingly common⁴⁸ method of corporate control is through the use of executive pay incentives, including stock options.⁴⁹ By tying an executive's pay to the price of a corporation's stock, the executive's interests and motivations are thought to be more closely aligned with those of the shareholders.⁵⁰ The use of stock incentives has become particularly popular over the course of the last two decades,⁵¹ though the recent

Jeffery N. Gordon, *Closing Remark: What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1245 (2002).

³⁸ See PRINCIPLES, *supra* note 15, § 3.01 cmt. a (indicating that the executives manage the bulk of the corporation's day-to-day operational functions).

³⁹ See *supra* text accompanying notes 32-37.

⁴⁰ Tatsuta & Kummert, *supra* note 36, at 5-17.

⁴¹ These are generally characterized as market based corporate governance control mechanisms. See Glosserman, *supra* note 30, at 2.

⁴² *Id.*

⁴³ Additional mechanisms to ensure management oversight include, among other things, shareholder suits and information disclosure rights. See Pinto, *supra* note 27, at 329-30, 336-40.

⁴⁴ See Mike Wright et al., *Venture Capitalists, Buy-Outs and Corporate Governance*, in CORPORATE GOVERNANCE 147 (Kevin Keasey et al. eds., 1997).

⁴⁵ See ROBERT A. HAUGEN MODERN INVESTMENT THEORY 202-04 (4th ed. 1997)

⁴⁶ Pinto, *supra* note 27, at 329-30.

⁴⁷ See *id.* at 335-37; see also Wright et al., *supra* note 44, at 147-48, 152-55 (describing the characteristics of leveraged buy-outs of publicly traded corporations and arguing that, in the event of takeover, the result is likely to be improved performance and re-focused executive management).

⁴⁸ Bruce & Buck, *supra* note 29, at 87.

⁴⁹ See Gordon, *supra* note 37, at 1245.

⁵⁰ See *id.*

⁵¹ Bruce & Buck, *supra* note 29, at 87.

American corporate scandals have prompted a serious reassessment of their effectiveness and desirability.⁵²

American corporations are thus governed by a system designed to maximize shareholder value and limit agency costs by harnessing the self-interests of autonomous corporate actors.⁵³ Separating the board of directors from the executive officers is an essential part of this corporate governance system and is further supported by a number of market forces and the use of executive pay incentives. With the American model growing increasingly dominant in the global economy,⁵⁴ nations that employ markedly different corporate governance models are under increased pressure to adopt the American model or a competitive alternative.⁵⁵ This is particularly true in the case of Japan.⁵⁶

III. PROSPERITY, RECESSION, AND THE PETRIFICATION OF JAPAN'S CONVENTIONAL CORPORATE GOVERNANCE MODEL

Despite similar theoretical starting points⁵⁷ and some similarities in statutory form,⁵⁸ Japanese corporations currently tend to employ a corporate governance model⁵⁹ that is markedly different from the model of their American counterparts.⁶⁰ The absence of a separate executive officer organ, together with a too-powerful chief executive and inadequate statutory auditors⁶¹ creates a corporate governance system that provides few controls

⁵² See generally John Cassidy, *The Greed Cycle*, NEW YORKER, Sept. 23, 2002 (discussing the history of the use of stock options in American corporations and their relationship to the recent wave of American corporate scandals).

⁵³ See Kissane, *supra* note 30, at 624-25.

⁵⁴ See Craig LaChance, *Nature v. Nurture: Evolution, Path Dependence and Corporate Governance*, 18 ARIZ. J. INT'L & COMP. L. 279 (2001) (discussing the potential convergence of corporate governance practices into a uniform global standard); *but see* West, *supra* note 13, at 589 (arguing that complete, near term convergence of corporate governance norms is unlikely).

⁵⁵ See Japan External Trade Organization, *Japan's Changing Economic Laws & Regulations*, Oct. 28, 2002, at http://www.jetro.go.jp/it/e/pub/changing2001/5_1.html (last visited Feb. 24, 2003) [hereinafter *Japan's Changing Laws*].

⁵⁶ Makoto Komiyama & Yukinobu Masaoka, *Corporate Governance, A New Phase for Japanese Companies 2*, Nomura Research Institute, at <http://www.nri.co.jp/english/report/papers/2002/pdf/np200247.pdf> (May 1, 2002).

⁵⁷ West, *supra* note 13, at 529.

⁵⁸ *Id.*

⁵⁹ Hereinafter, this Comment will refer to this as Japan's conventional corporate governance model.

⁶⁰ Nevertheless, Japanese corporations are similarly vulnerable to the fundamental problems inherent to the corporate form. See Zenichi Shishido, *Japanese Law Symposium, Reform in Japanese Corporate Law and Corporate Governance: Current Changes in Historical Perspective*, 49 AM. J. COMP. L. 653, 654 (2001).

⁶¹ Statutory auditors are a corporate supervisory organ unique to Japan and designed to audit and oversee the board of directors. See *infra* notes 84-91 and accompanying text.

on executive action and little emphasis on shareholders.⁶² Moreover, corporate norms emphasizing hierarchy and community further undermine the possibility of effective oversight.⁶³ Although robust economic growth and a unique system of industrial organization enabled this system to survive for decades, Japan's recent recession and an unwinding of cross-shareholding patterns render it increasingly ineffective.⁶⁴ Consequently, Japan faces mounting pressure to provide an alternative model.

A. Japan's Conventional Corporate Governance Model Provides Weak Oversight and Affords Few Shareholder Protections

One of Japan's most distinctive corporate governance features, and a chief source of its inability to effectively oversee executives, is the combination of executive and board functions. Unlike American corporate law, the Code does not provide for executive officer positions.⁶⁵ Instead, it is common for corporations to confer on its directors titles that Americans typically associate with executive officers.⁶⁶ Executive titles therefore do not relate to executive officers as a separate body, but rather to sitting board members that hold concurrent officer titles. This arrangement frustrates the separation of operational and oversight powers contemplated by the American model, essentially leaving the board to oversee itself.⁶⁷

The concentrated power of the board's representative director further limits its oversight ability and thwarts deliberative decision-making processes.⁶⁸ The Code requires Japanese boards to appoint from its members at least one "representing director" ("*daihyo torishimariyaku*")⁶⁹ to act on the behalf of the corporation and to represent it regarding most external matters.⁷⁰ To this end, the representative director has broad power

⁶² Takashi Araki, *Employees and Corporate Governance: Japan: A Comparative Analysis: Corporate Governance and Labor and Employment Relations in Japan*, 22 COMP. LAB. L. & POL'Y J. 67, 77-78 (2000); see also *Japan's Changing Laws*, *supra* note 55.

⁶³ See Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions*, 25 DEL. J. CORP. L. 189, 213-14, (2000).

⁶⁴ See *infra* notes 98-108 and 120-26 and accompanying text.

⁶⁵ Nevertheless, virtually all Japanese corporations provide for them in their articles of incorporation. 1 DOING BUSINESS IN JAPAN § 9.07(2) (Zentaro Kitagawa ed., 1996).

⁶⁶ See Miwa, *supra* note 13, at 1231.

⁶⁷ Araki, *supra* note 62, at 91.

⁶⁸ RODNEY CLARK, *THE JAPANESE COMPANY 100* (1979) (indicating that the hierarchical nature of Japanese boards of directors in general stands as a barrier to "critical discussion").

⁶⁹ SHŌHŌ [Commercial Code] art. 261, para. 1 (Japan) (representing director is often also referred to in the literature as a "representative director"; that is the term used herein).

⁷⁰ KOJI MATSUMOTO, *THE RISE OF THE JAPANESE CORPORATE SYSTEM; THE INSIDE VIEW OF A MITI OFFICIAL 7* (Thomas I. Elliot trans., Kegan Paul International Ltd. 1993) (1983).

to act in all “judicial and extra-judicial acts relating to the business of the corporation.”⁷¹

The representative director’s power, however, is much broader than the letter of the Code indicates. In reality, the representative director typically directs the internal operational policies of the corporation,⁷² appoints and removes the other directors,⁷³ and sits as the chairman of the board.⁷⁴ Since the representative director is generally considered the highest position in the corporation, virtually no other corporate actor can challenge his authority.⁷⁵ It is equally unlikely that the representative director could be removed for poor performance.⁷⁶ Consequently, the representative director, not the board as a whole, determines the corporation’s day-to-day business,⁷⁷ serves as its key management figure,⁷⁸ and is functionally accountable to no one.⁷⁹

The insider nature of Japanese boards also serves as a substantial impediment to their ability to serve shareholder interests and ensure executive accountability. Japanese boards typically consist of insiders promoted from the company’s senior and middle management.⁸⁰ Indeed, the title of director carries great prestige within the company hierarchy⁸¹ and is therefore virtually impossible to award to company outsiders.⁸² Since nearly all executive officers and directors are elected from the ranks of corporate

⁷¹ SHŌHŌ [Commercial Code] art. 261, para. 3 (Japan).

⁷² MATSUMOTO, *supra* note 70, at 7.

⁷³ Kazuo Noda, *Big Business Organization in Part Two Economic Organization*, in MODERN JAPANESE ORGANIZATION AND DECISION-MAKING 120-21 (Ezra F. Vogel ed., 1975).

⁷⁴ *Id.* at 122.

⁷⁵ MATSUMOTO, *supra* note 70, at 9.

⁷⁶ *Id.* (indicating that, in such instances, it is more likely that a director who made such a suggestion would be removed instead).

⁷⁷ DOING BUSINESS IN JAPAN, *supra* note 65, § 9.07(7).

⁷⁸ See Tatsuta & Kummert, *supra* note 36, at 5-16 (1996).

⁷⁹ MATSUMOTO, *supra* note 70, at 9. Additionally, a few senior directors, possibly in conjunction with the representative director, may dominate a particular board. See Curtis J. Milhaupt, *Symposium Norms & Corporate Law: Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2091 (2001) [hereinafter Milhaupt, *Symposium*].

⁸⁰ Ordinarily, the board is comprised of a chairman and the heads of the firm’s various departments. TOYOHIRO KONO, STRATEGY AND STRUCTURE OF JAPANESE ENTERPRISES 23 (1984).

⁸¹ As many as four distinct ranks of directors may exist within any particular board, each of which is subordinate to the representative director. See CLARK, *supra* note 68, at 99-103.

⁸² Some argue that the insular nature of the board shields it from the pressures of ownership and enables it to focus on long-term growth for the benefit of the employees at the expense of short-term profit. See KONO, *supra* note 80, at 23; but see Bradley et al., *supra* note 28, at 57 (indicating that one exception may be main bank representatives that sit as board members of *keiretsu* firms with whom they do business).

insiders, their loyalty is first to their company peers and second to larger stakeholders, including shareholders.⁸³

Japan's last supervisory line of defense, the unique statutory auditor system, also fails to serve as an effective mechanism to prevent executive abuse or safeguard shareholder interests. The Code requires Japanese corporations to employ one or more⁸⁴ statutory auditors ("*kansayaku*") to "audit the execution by the directors of their functions."⁸⁵ However, the statutory auditor system is widely recognized as a weak supervisory organ⁸⁶ that has "had little real function" since its inception in 1896.⁸⁷ One key weakness of the statutory auditors is that their power is narrowly defined to cover only legal compliance and accounting functions.⁸⁸ They do not have a vote on the board nor are they charged with the responsibility of monitoring the overall performance of management.⁸⁹ Moreover, auditors tend to be retired employees or employees of affiliated firms who are given the title as a token of appreciation.⁹⁰ As a result, auditors are generally considered to have lower stature within the corporate hierarchy, which stands as a serious impediment to their performance of even basic monitoring and compliance functions.⁹¹

These Japanese practices and structures result in a corporate governance system that is far different than its American analogue. Whereas American corporations rely on a clear separation of board and executive officer functions, Japanese firms combine the two and concentrate decision-making power in the hands of a representative director. Additionally, weak statutory authority and social norms prevent auditors from exercising any truly effective oversight. The result is a corporate

⁸³ See Shishido, *supra* note 63, at 213 (arguing that when performance is weak, internal social pressures from the "Company Community" force failing executives to resign or be removed and, thus, that all members of the firm have an incentive to ensure economic success).

⁸⁴ For large corporations (whose capital is five hundred million yen or more or whose total liabilities are one hundred million yen or more) at least three statutory auditors are required. See DOING BUSINESS IN JAPAN, *supra* note 65, § 9.08(1).

⁸⁵ SHŌHŌ [Commercial Code] art. 274 (Japan). To this end, auditors are granted a variety of investigative and reporting functions. DOING BUSINESS IN JAPAN, *supra* note 65, § 9.08(2). For instance, directors must report to the auditor problems that might cause serious harm to the corporation. SHŌHŌ [Commercial Code] arts. 274-72 (Japan). Auditors also have the power to request at any time that the directors report on the operation of the company. *Id.* art. 274, para. 2. They may also demand that a director cease any act that is *ultra vires* or otherwise in violation of the law. *Id.* art. 275-72.

⁸⁶ See Noda, *supra* note 73, at 118-20.

⁸⁷ *Id.* at 119.

⁸⁸ Araki, *supra* note 62, at 77-78.

⁸⁹ See generally SHŌHŌ [Commercial Code] arts. 273-80 (Japan).

⁹⁰ Michael Solomon Associates, Inc., *Commercial Code Revisions Strengthen Board Oversight Role*, 1 JAPAN CORPORATE GOVERNANCE REPORT 1 (July 2002) <http://www.msapr.com/JCGR%20July%20English.pdf>. (last visited Jan. 5, 2003).

⁹¹ MATSUMOTO, *supra* note 70, at 9-10.

governance model in which executive oversight and shareholder interests appear to be almost a total fiction.⁹²

B. Economic Changes Expose the Weaknesses of Japan's Conventional Corporate Governance Model

Although a unique combination of industrial organization and economic success throughout much of the post-war period may have enabled Japan's conventional corporate governance model to persist, domestic recession, unwinding of cross-shareholdings, and competition in an increasingly global economy are pressuring Japan to change.⁹³ Japan's ongoing recession has led to an unwinding of cross-shareholding patterns, which has both opened the door to more activist foreign shareholders and forced more Japanese firms to compete directly with foreign firms for capital.⁹⁴ Since global investors increasingly view corporate governance as a key investment criterion,⁹⁵ Japan is being pushed to reassess the viability of its conventional model.⁹⁶

1. Industrial Organization and Economic Success Allowed Japan's Conventional System to Persist, Despite Its Deficiencies

Japan's unique forms of industrial organization and astounding post-war economic success are chief reasons the conventional corporate governance system persists.⁹⁷ For instance, one of the hallmarks of Japanese industry is the organization of many Japanese corporations into groups

⁹² *Id.* at 9.

⁹³ See Japan External Trade Organization, *Bringing in Outsiders to Oversee Management*, at http://www.jetro.org/newyork/info_on_japan/jetro_reports/corpgov.pdf (last visited Jan. 5, 2003) [hereinafter *Bringing in Outsiders*].

⁹⁴ *Id.*; see also Narusawa et al., *supra* note 2, at 10.

⁹⁵ See, e.g., Gregory, *supra* note 11, at 2.

⁹⁶ According to Tomomi Yano, manager of Japan's Pension Fund Association, "[t]he biggest problem [with Japanese companies] is inadequate oversight. For the market to improve, we need to improve the profitability of each corporation, and we won't be able to accomplish that without reforming [corporate] governance structures." Michael Solomon Associates, Inc., *Interview with Tomomi Yano of the Pension Fund Association*, 3 JAPAN CORPORATE GOVERNANCE REPORT 2, (2002) <http://www.msapr.com/English%20JCGReport%20November.pdf> (last visited Jan. 5, 2003) [hereinafter *Interview with Tomomi Yano*].

⁹⁷ A number of commentators have analyzed the Japanese system and found it to have many strengths, including the freedom of Japanese firms to set long term goals without being overly burdened by pressures to deliver short term gains. See, e.g. Howard D. Sherman & Andrew Babcock, *Redressing Structural Imbalances in Japanese Corporate Governance*, in *STUDIES IN INTERNATIONAL CORPORATE AND FINANCE AND GOVERNANCE SYSTEMS* 267-68 (Donald H. Chew ed., 1997); see generally JAMES C. ABEGGLEN & GEORGE STALK, JR., *KAISHA, THE JAPANESE CORPORATION* (1985) (positively evaluating many facets of Japanese management).

called *keiretsu*.⁹⁸ These *keiretsu* are characterized by “stable cross-share ownership, interlocking directorates, extensive product market exchanges, and other linkages that enhance group identity and facilitate information exchange.”⁹⁹ Frequently, these groups are centered around a main bank that holds various member company shares and provides capital and other types of assistance.¹⁰⁰ Indeed, approximately two-thirds of all corporate shares in Japan are held in these kinds of stable, management-friendly arrangements.¹⁰¹

A negative result of these *keiretsu* cross-shareholding arrangements, however, is management inattention to shareholder interests.¹⁰² Because corporations will maintain their cross shareholdings in order to preserve *keiretsu* business relationships, regardless of share performance,¹⁰³ directors have little real reason to fear losing their jobs for poor performance,¹⁰⁴ except in times of serious trouble.¹⁰⁵ The almost unwavering faith of inside shareholders in established executive management is further evidenced by the practice by institutional shareholders of submitting blank proxy statements at annual shareholder meetings.¹⁰⁶ In this way, inside shareholders show little regard to the performance of executive management and instead tend to follow its lead.¹⁰⁷ Ultimately, cross-shareholding arrangements elevate the relationship of the majority shareholders at the expense of other shareholders and render attention to shareholder value a low priority.¹⁰⁸

Japan’s astounding post-war economic success compounded these trends. After decades of growth, by 1990, Japan had emerged as the world’s second largest economy¹⁰⁹ and seemed to be “an unstoppable economic

⁹⁸ Milhaupt, *supra* note 20, at 25-26.

⁹⁹ *Id.*

¹⁰⁰ Bradley et al., *supra* note 28, at 57; see also Sherman & Babcock, *supra* note 97, at 267-68.

¹⁰¹ Milhaupt, *supra* note 20, at 25-26. *Keiretsu* also serve as an anti-takeover device, as well as a method for providing corporate monitoring and bonding. *Id.*; see also Miwa, *supra* note 13, at 1231 (indicating that shareholders rarely oust management).

¹⁰² Poe et al., *supra* note 4, at 77-78.

¹⁰³ MATSUMOTO, *supra* note 70, at 5.

¹⁰⁴ *Id.*

¹⁰⁵ Glosserman, *supra* note 30, at 1.

¹⁰⁶ *Id.* at 5-6. The use of general meeting mongers or *sokaiya*, who are paid to suppress dissent and over-inquisitiveness during shareholder meetings is also not uncommon. CLARK, *supra* note 68, at 102-03.

¹⁰⁷ MATSUMOTO, *supra* note 70, at 6.

¹⁰⁸ Poe, et al., *supra* note 4, at 78.

¹⁰⁹ See Japan External Trade Organization, *Japanese Economy Offers Investors a Source of Global Diversity* (July 29, 2002), at <http://www.jetro.org/newyork/focusnewsletter/focus19.html> (last visited Feb. 23, 2003).

machine on the road to dominating the world economy.”¹¹⁰ Throughout this period of prosperity, as long as employees and other stakeholders benefited and returns on shares held by insiders were sufficient, shareholder interests were subordinated and conflicts between management and shareholders were simply overlooked.¹¹¹ Thus, Japanese inside shareholders and business leaders were indifferent to the system’s deficiencies as long as Japan was prosperous.

2. *Recent Economic Pressures Demand Reform of Japan’s Conventional Corporate Governance Model*

Although Japan’s conventional corporate governance model seemed to serve its corporations exceptionally well for decades,¹¹² it has been increasingly viewed as the source of economic failure¹¹³ and corporate scandal¹¹⁴ ever since the bursting of the economic bubble.¹¹⁵ A decade-long recession has instigated an unwinding of cross-shareholdings, which has in turn led to the growth of foreign investment in Japan and enhanced competition for direct capital financing.¹¹⁶ These changes are forcing Japan to address the viability of its conventional corporate governance practices more than ever before.¹¹⁷

One key reason for Japan’s inability to ignore reform of its conventional corporate governance practices is the rapid unwinding of cross-shareholding patterns.¹¹⁸ As Japan’s recession drags on, corporations increasingly feel pressure to improve their bottom lines.¹¹⁹ More and more, corporations have shown a willingness to sell off cross-shareholdings in non-performing companies.¹²⁰ Indeed, cross-shareholdings accounted for 45% of shares held a decade ago, whereas they accounted for just 34.1% by 2001.¹²¹ Moreover, recent changes to Japan’s corporate accounting rules are likely to create an even greater incentive for corporations to sell their poorly

¹¹⁰ GERALD L. CURTIS, *THE LOGIC OF JAPANESE POLITICS: LEADERS, INSTITUTIONS, AND THE LIMITS OF CHANGE* 72 (1999).

¹¹¹ See *Bringing in Outsiders*, *supra* note 93.

¹¹² See discussion *supra* Part III.B.1.

¹¹³ See, e.g., Glosserman, *supra* note 30, at 1.

¹¹⁴ See, e.g., Goldstein, *supra* note 3; Rapoport, *supra* note 3.

¹¹⁵ This term refers to the stock market bubble and inflated land prices of the late 1980s.

¹¹⁶ See *Bringing In Outsiders*, *supra* note 93.

¹¹⁷ Komiyama & Masaoka, *supra* note 56, at 2.

¹¹⁸ *Id.*

¹¹⁹ See *id.*

¹²⁰ Araki, *supra* note 62, at 71.

¹²¹ Glosserman, *supra* note 30, at 3.

performing shareholdings.¹²² As a result, Japanese firms must increasingly compete directly against foreign firms for capital financing.¹²³ With corporate governance topping the concerns of international investors,¹²⁴ Japanese companies are under increasing pressure to provide investors a corporate governance system that provides accountability and continuous profit.¹²⁵ In short, they must become more focused on providing shareholder value.¹²⁶

Concurrently, the influence of more activist foreign investors in Japan has grown significantly over the past several years.¹²⁷ Between 1990 and 1998 alone, the ratio of foreign to domestic shareholders among corporations listed on the Tokyo Stock exchange more than doubled.¹²⁸ Similarly, foreign mergers and acquisitions set a new record in Japan in 2001 for the fourth straight year, indicating growing acceptance of foreign business alliances.¹²⁹ The result of this trend is that even Japanese firms that raise capital domestically are feeling pressure to devise executive management structures that generate the continuous profit growth expected by foreign shareholders.¹³⁰

Recognizing and adapting to these new economic realities is a critical issue for Japanese companies if they are to successfully compete in an increasingly global economy that demands accountability in corporate governance.¹³¹ According to the Organization for Economic Cooperation and Development, ("OECD"), "good corporate governance . . . ensures transparency, fairness and accountability . . . [and] is a prerequisite for the integrity and credibility of market institutions."¹³² The growing importance of corporate governance was highlighted at the 1998 meeting of the then G-

¹²² These new rules require that shares be assessed at their more volatile market value rather than their book value. Poe et al., *supra* note 4, at 77.

¹²³ See *Bringing in Outsiders*, *supra* note 93.

¹²⁴ See Gregory, *supra* note 11.

¹²⁵ See Komiyama & Masaoka, *supra* note 56, at 2.

¹²⁶ Poe et al., *supra* note 4, at 77.

¹²⁷ See Komiyama & Masaoka, *supra* note 56, at 2.

¹²⁸ See Hiroyuki Takahashi, *Corporate Governance In Japan: Reform of Top Corporate Management Structure*, JAPAN ECONOMIC INSTITUTE 7 (July 23, 1999), at <http://www.jei.org/Archive/JEIR99/9928A.pdf> (last visited Jan. 5, 2003).

¹²⁹ It is possible to infer from such trends that the acceptability of foreign corporate governance methods may also be met with increasing acceptance. See *New Business Practices*, *supra* note 1.

¹³⁰ See Komiyama & Masaoka, *supra* note 56, at 2. The growing influence of such activist foreign investors may also be influencing domestic institutional investors. According to Tomomi Yano of Japan's Pension Fund Association, Japanese pension fund investors are becoming increasingly vociferous of their shareholder interests. See *Interview with Tomomi Yano*, *supra* note 96.

¹³¹ See Komiyama & Masaoka, *supra* note 56, at 2; see also *Bringing in Outsiders*, *supra* note 93.

¹³² Bill Witherell, *Corporate Governance and Responsibility Foundations of Market Integrity*, 234 OECD OBSERVER 8 (Oct. 2002), at <http://www.oecd.org/pdf/M00036000/M00036447.pdf> (last visited Feb. 11, 2003).

7 leading industrialized nations, where corporate governance was identified as one of the key pillars of the emerging global economy.¹³³ Since that time, international organizations, including OECD, have been developing international standards for corporate governance.¹³⁴ Although Japan's corporate governance practices continue to fall short of international standards,¹³⁵ the recent Amendment to the Code enabling Japanese corporations to adopt an American-style executive officer system is a key step towards substantive reform.

IV. THE AMENDMENT

Responding to these pressures, the Diet passed the Amendment to enable Japanese corporations to adopt an American-style executive officer system in May 2002.¹³⁶ The Amendment expands on the Code's previous provisions by creating at least two distinct corporate governance options for Japanese firms. Companies can either maintain the conventional system, subject to several modifications, or move entirely to an American-style system, including officers and a board of directors with three committees.¹³⁷

A. *Pre-Amendment Corporate Governance: Adoption of American-Style Executive Officer Systems*

Pre-Amendment action by Japanese corporations reveals much about the Amendment's form and potential impact. Prior to the Amendment, there was simply no Code provision that enabled firms to adopt the executive officer system.¹³⁸ Rather, Japanese firms were simply left to employ the conventional governance system.¹³⁹ Nevertheless, many of Japan's leading

¹³³ Glosserman, *supra* note 30, at 2.

¹³⁴ See, e.g., ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, PRINCIPLES OF CORPORATE GOVERNANCE (adopted May 1999), <http://www.oecd.org/pdf/M00008000/M00008299.pdf> (last visited Feb. 11, 2003).

¹³⁵ According to a 2002 study by the Japan Corporate Governance Index Research group, Japanese firms score especially low in category two of the Index, "Structure and Function of the Board of Directors." See, Takaki Wakasugi et al., *Report on the 2002 Corporate Governance Survey*, JAPAN CORPORATE GOVERNANCE INDEX RESEARCH GROUP 5 (Sept. 2, 2002), <http://www.jcgr.org/eng/research/report20020902eng.pdf> (last visited Feb. 11, 2003) [hereinafter JCGI]. Scores in this category were on average just 7.3 out of 29 total possible points, a result the study found indicates that the "functions of the board of directors and operating officers have not yet been sufficiently separated." *Id.*

¹³⁶ See Araki, *supra* note 62, at 91 n.60.

¹³⁷ See discussion *supra* Part III.B.

¹³⁸ However, no provision in the Commercial Code specifically prohibited the use of executive officers either. See *supra* notes 65-67 and accompanying text.

¹³⁹ See discussion *supra* Part III.

multinational firms adopted the system before the Code even provided for it.¹⁴⁰ Foremost among these corporate governance pioneers was Sony, whose 1997 corporate reforms included the adoption of an executive officer system.¹⁴¹ This highly publicized change was extremely influential in the Japanese business community and resulted in similar changes by almost two hundred other major Japanese corporations, including Toshiba Corp., Japan Airlines, and Nissan Motor Co., Ltd.¹⁴² Many of the structures adopted by these corporations, including the executive officer system, are now embodied in the Amendment.¹⁴³ Thus, the actions of these pioneering firms seemed to play an important role in passing the Amendment.

Pre-Amendment adoption of the executive officer system also indicates that the Amendment's impact will be rapid. Demand pull reforms are changes to the Code that are instigated by underlying changes in Japanese corporate practices, the background economic market, and social norms.¹⁴⁴ These business-driven reforms tend to have a direct influence on corporate practices and, because they are driven by business exigencies, are generally adopted quickly.¹⁴⁵ Several surveys indicate this is the case with the Amendment. According to a 2001 survey conducted by the *Nihon Keizai Shimbun*,¹⁴⁶ 35.7% of the companies surveyed had "already introduced an executive officer system," while an additional 14.1% were "studying its [possible] introduction."¹⁴⁷ According to a survey reported by the *Asahi Shimbun*,¹⁴⁸ however, by May 2002, only 6% of responding corporations intended to adopt the American-style system.¹⁴⁹ These results indicate that the bulk of corporations planning to utilize the system had already done so by the time the Amendment passed.

¹⁴⁰ See Takahashi, *supra* note 128. Hiroyuki Takahashi has compiled a table listing several of the most well-known Japanese companies that have adopted an American-style system. *Id.* at 3.

¹⁴¹ *Id.* at 7; Takahashi discusses in greater detail the specific changes involved in Sony's reforms. *Id.* at 4-5.

¹⁴² Milhaupt, *Symposium, supra* note 79, at 2117-18; see also Takahashi, *supra* note 128, at 3.

¹⁴³ Compare Takahashi, *supra* note 128, at 9 (discussing Sony's introduction of executive officers and a board system implementing three committees) with discussion *infra* Part IV.B. (discussing nearly identical features embodied in the Commercial Code).

¹⁴⁴ Shishido, *supra* note 60, at 671-72.

¹⁴⁵ *Id.* at 671-74.

¹⁴⁶ *Nihon Keizai Shimbun* is one of Japan's leading business newspapers.

¹⁴⁷ The total of these two groups was almost 50% of respondents. Komiyama & Masaoka, *supra* note 56, at 4.

¹⁴⁸ *Asahi Shimbun* is one of Japan's leading daily newspapers.

¹⁴⁹ *External Directors Seen As Key To Investor Confidence*, ASAHI SHIMBUN, May 21, 2002, available at 2002 WL 20828790.

B. *The Amendment: Corporate Governance Options Are a Step Towards an American-Style Executive Officer System*

The Amendment contemplates at least two distinct corporate governance¹⁵⁰ schemes which corporations can select based on their particular business needs.¹⁵¹ The first option is the conventional Japanese model, employing the board of directors, no separate executive body, and the statutory auditors.¹⁵² For corporations that choose to retain the conventional system, the Amendment requires certain modifications that strengthen the role of the statutory auditors.¹⁵³ These modifications require that large corporations have at least three auditors with a majority of them being “outside” auditors.¹⁵⁴ The Amendment defines “outside” as those auditors who have not “been a director, general manager or an employee in some other capacity of the company or its subsidiaries.”¹⁵⁵ Additionally, the Amendment enables firms that retain the modified conventional system to create an Important Assets Committee within the board of directors “as a minimal system to enhance operational efficiency.”¹⁵⁶ However, it is unclear exactly what purpose or effect such a committee would have on corporate governance.¹⁵⁷

Alternatively, the Amendment offers the option of implementing an executive officer system substantially similar to the American model.¹⁵⁸ A corporation with more than two outside directors may elect to abandon the conventional system entirely and replace it with an American-style officer system.¹⁵⁹ Corporations opting for the new system must install at least one executive officer to focus primarily on the corporation’s operational affairs.¹⁶⁰ Officers are appointed by the board of directors¹⁶¹ and are

¹⁵⁰ See *Japan’s Changing Laws*, *supra* note 55 (providing a useful, basic illustration of the differences between these two systems).

¹⁵¹ See Motomi Hashimoto, *Commercial Code Revisions: Promoting the Evolution of Japanese Companies*, NOMURA RESEARCH INSTITUTE 10 (May 1, 2002), at <http://www.nri.co.jp/english/report/papers/2002/pdf/np200248.pdf> (last visited Feb. 10, 2003).

¹⁵² See discussion *supra* Part III.

¹⁵³ *Bringing in Outsiders*, *supra* note 93, at 3; see also Torikai Law Office, *Review of the Law 44 Amendment* (Nov. 12, 2002), at <http://www.torikai.gr.jp/> (Hirosuke Yanagida, trans.) [hereinafter *Torikai Review*].

¹⁵⁴ *Bringing in Outsiders*, *supra* note 93, at 3.

¹⁵⁵ See *id.* (indicating that these requirements are in addition to a December 2001 amendment to the Commercial Code extending the length of auditor terms from three to four years).

¹⁵⁶ See *Torikai Review*, *supra* note 153.

¹⁵⁷ See *id.*

¹⁵⁸ See discussion *supra* Part II.B.

¹⁵⁹ See *Torikai Review*, *supra* note 153.

¹⁶⁰ See *Bringing in Outsiders*, *supra* note 93.

¹⁶¹ See *Torikai Review*, *supra* note 153.

delegated a number of the operational responsibilities previously held by the board-officers, including selling and purchasing important corporate assets,¹⁶² opening and closing branch offices,¹⁶³ and approving stock splits.¹⁶⁴ Officers are also obliged to report to the shareholders at the annual meeting, to the board every quarter, and to the auditing committee with respect to major issues facing the company.¹⁶⁵ In short, officers are specifically charged with conducting the corporation's day-to-day business operations.¹⁶⁶ Thus, the Amendment more clearly separates the authority of the management oversight organ, the directors, from the operational executive organ, the officers, in much the same way as the American model.

It is important to note, however, that the separation contemplated by the new scheme is not entirely distinct. Directors can still serve concurrently as executive officers.¹⁶⁷ In fact, the Amendment requires at least one director to serve as the corporation's chief executive officer ("CEO").¹⁶⁸ Additionally, the statutory definition of "outside" does not appear to apply to executive officers or to individuals from parent corporations or other affiliated corporations.¹⁶⁹ Moreover, the term "outside" does not seem to apply to individuals with other financial interests in the corporation.¹⁷⁰

Corporations installing the American-style executive officer system must also adopt a board of directors with three committees.¹⁷¹ In addition to requiring at least two outside directors to sit on the board,¹⁷² the Amendment requires the creation of appointment, compensation and auditing committees.¹⁷³ The appointment committee will be empowered to select and dismiss board members, while the compensation committee will be charged

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ Poe et al., *supra* note 4, at 86.

¹⁶⁷ See *Torikai Review*, *supra* note 153 (indicating that an exception to this provision is that members of the Auditing Committee may not be executive officers or chief managers of the corporation or its subsidiaries).

¹⁶⁸ See *Bringing in Outsiders*, *supra* note 93.

¹⁶⁹ See *id.* at 3.

¹⁷⁰ See *id.*; Gordon, *supra* note 37, 1241-43 (identifying less formal relationships and side payments as forces corrupting executive and director independence and leading, at least in part, to the Enron collapse). The ambiguities in the Amendment leave the door open to allowing these types of less formal insiders to serve in positions designated as outside and may potentially be susceptible to a similar fate.

¹⁷¹ See *Bringing in Outsiders*, *supra* note 93. Although it is not the subject of this Comment to address the ramifications of the changes to the Commercial Code concerning the board of directors, it is necessary to briefly discuss them here to the extent that they relate to executive oversight issues.

¹⁷² *Torikai Review*, *supra* note 153.

¹⁷³ *Id.*

with determining the compensation packages for each director and officer.¹⁷⁴ The auditing committee will select and dismiss outside auditors and also monitor the performance of both directors and executive officers.¹⁷⁵ Each of these committees must consist of at least three members with a majority of them being corporate outsiders and non-executives.¹⁷⁶ Additionally, members of the auditing committee must be independent.¹⁷⁷

The result of the Amendment is a statutory framework that more clearly separates the executive officers from the board of directors. In this sense, the new system provides a workable framework for potentially more effective oversight and improved decision-making processes.¹⁷⁸ The framework contemplated by the Amendment, however, does not exist in a vacuum and is therefore likely to be limited, perhaps severely, by a number of legal and cultural obstacles.

V. THE AMENDMENT IS AN IMPORTANT EARLY STEP IN REFORMING JAPAN'S CORPORATE GOVERNANCE PRACTICES, BUT WILL FALL SHORT OF INSTITUTING SYSTEMIC REFORM

The Amendment is a direct result of a genuine shift in Japanese corporate governance practices and represents one of the first key steps towards a gradual reorienting of Japanese firms from stakeholder-based to shareholder-centered.¹⁷⁹ By providing Japanese corporations with the option to create a separate executive organ, the Amendment provides a framework for a system potentially more efficient and more accountable to shareholders.¹⁸⁰ Nevertheless, the impact of the Amendment will likely be hindered by flaws in the Amendment itself and the influence of already entrenched Japanese business culture and practices.

¹⁷⁴ See *Bringing in Outsiders*, *supra* note 93.

¹⁷⁵ *Id.*

¹⁷⁶ *Torikai Review*, *supra* note 153.

¹⁷⁷ *Id.*

¹⁷⁸ See discussion *supra* Part II.B.

¹⁷⁹ Gregory Jackson, *The Twilight of the Stakeholder Corporation? Germany's Relevance for Japan*, RESEARCH INSTITUTE OF ECONOMY TRADE AND INDUSTRY (Oct. 1, 2002), at http://www.rieti.go.jp/en/columns/a01_0057.html (last visited Feb. 10, 2003).

¹⁸⁰ Milhaupt, *Symposium*, *supra* note 79, at 2117-18.

A. *The Amendment Provides a Workable Framework upon Which Meaningful Corporate Governance Reform Can Occur*

The Amendment's statutory framework for the executive officer system is capable by itself of improving board oversight decision and shareholder value¹⁸¹ for those corporations that make reform a priority. From a structural standpoint, executive officers are a separate body under the new arrangement and are subject to review and removal by the independent auditing committee.¹⁸² This arrangement should force executives to be more accountable for their decisions and raise executive responsiveness to shareholder interests vis-a-vis the board. Moreover, because executive officers are no longer required to concurrently serve as directors, they are no longer required, by definition, to have a vote on the board.¹⁸³ If executives are no longer voting peers alongside directors, they are likely to be more accountable to the directors as a body. These simple realities may sever, or more likely, limit the power of hierarchy that once all but eliminated the possibility of executive oversight.

These structural changes may also improve decision-making efficiency.¹⁸⁴ With executive officers separate from the board and therefore free to make operational decisions, the decision-making process will be streamlined. Moreover, by separating the board from the officers, officers will be able to focus on and become more proficient at operational functions.

Sony's experience with corporate governance reform provides an illustration of how the executive officer system may serve as a transitional step towards better corporate governance models in the near future.¹⁸⁵ Sony's 1997 corporate governance reforms included a new organizational format that structurally separated its executive officers from the board of directors.¹⁸⁶ Sony also introduced several changes to its board of directors, including the creation of several board committees and an increase in the number of outside directors.¹⁸⁷ Although Sony did retain its old directors as

¹⁸¹ See JCGI, *supra* note 135, at 1.

¹⁸² See *Torikai Review*, *supra* note 153; see also *Bringing in Outsiders*, *supra* note 93.

¹⁸³ See *Torikai Review*, *supra* note 153.

¹⁸⁴ *Id.*

¹⁸⁵ Potential problems with Sony's changes may also exist. See discussion *infra* Part V.B.3.

¹⁸⁶ Takahashi, *supra* note 128, at 4-5. Sony also reduced the board size from thirty-eight to ten and increased the number of outside directors to three in order to improve board oversight of the officers. *Id.* Initially, Sony created twenty-seven officer positions but later increased that number to thirty-seven. *Id.* Many of Sony's officers are former directors who were not fired, but rather were shifted into the role of executive officer. *Id.* Finally, the chief executive and chief operating officers may concurrently hold representative director positions. *Id.*

¹⁸⁷ Takahashi, *supra* note 128, at 4-5.

officers, this change was intended to effectuate the implementation of the executive system, while helping to maintain the morale of the ex-directors.¹⁸⁸ Recently, Sony announced that it has adopted the new corporate governance provisions provided by the Amendment.¹⁸⁹ Perhaps other large firms will follow Sony's path and make similar transitions.

B. *Legal and Cultural Obstacles Will Limit the Amendment's Impact*

Despite the usefulness of the corporate governance framework provided by the Amendment, a number of legal and cultural obstacles promise to prevent it from serving as Japan's corporate governance panacea. The optional nature of the Amendment, strong preference for Japanese business practices, the persistence of corporate norms emphasizing hierarchy and community, and renewed suspicion of American corporate institutions following the recent wave of corporate scandals all stand as obstacles to widespread adoption of the new system.

1. *The Amendment's Optional Nature Will Limit Its Impact*

One important obstacle to the widespread implementation of the executive officer system is its optional nature.¹⁹⁰ Since the Amendment is a compromise measure designed to support implementation of the executive officer system by some of Japan's largest multinational corporations,¹⁹¹ it does not require all Japanese firms to adopt it.¹⁹² While the statutory support is undoubtedly important for those large multinational firms that have already adopted the system (or will do so in the near term), its optional nature frustrates it from generating change in Japan's most conservative firms, as well as its smaller and/or primarily domestic firms. In a nation where norms in corporate behavior tend to evolve slowly,¹⁹³ this feature of the Amendment may render it especially weak.

¹⁸⁸ *Id.* at 7.

¹⁸⁹ Sony Corporate Website, *Reforming the Sony Group Management Structure to Strengthen Corporate Governance* (Jan. 28, 2003), <http://www.sony.net/SonyInfo/News/Press/200301/03-004E/> (last visited Feb. 15, 2003).

¹⁹⁰ Michael Solomon Associates, Inc., *supra* note 90 (indicating that the initial proposal released for comment in April, 2001 was mandatory for all large corporations, but was scrapped in favor of the optional plan after heavy opposition from Japanese Big Business).

¹⁹¹ See discussion *supra* Part IV.

¹⁹² *Torikai Review*, *supra* note 153.

¹⁹³ Milhaupt, *Symposium*, *supra* note 79, at 2102 (discussing how Japanese corporate governance norms are "relatively impervious to change" because of the benefits they provided to various groups of powerful, private companies); see also West, *supra* note 13, at 587-588 (arguing that changes in Japanese law tend to come slowly and in response to shocks from outside sources).

2. *Japanese Business Leaders' Strong Preference for Japanese Models Will Hinder Widespread and Systemic Adoption of American-Style Models*

A strong preference among business leaders for Japanese corporate governance models is also a barrier to a wide-spread and systemic adoption of the executive officer system. While difficult to quantify, positions taken by some of Japan's most powerful business and political organizations strongly imply this is the case. For instance, the Japan Federation of Economic Organizations ("Keidanren")¹⁹⁴ and the ruling Liberal Democratic Party ("LDP") have shown their disfavor for substantive reform along American lines. Rather than advocating for adoption of the executive officer system, *Keidanren* proposed strengthening Japan's unique auditor system.¹⁹⁵ In response to *Keidanren's* concerns, the LDP's Judicial Affairs Division's Subcommittee on the Commercial Code recommended nearly identical changes in 1999.¹⁹⁶ Hiroshi Okuda, chairman of Toyota Motor Corp.¹⁹⁷ seemed to voice the sentiment underlying these proposals when he indicated in a 1999 keynote speech presented at the Nikkei Global Management Forum, that American-style management techniques (such as the executive officer system) are foreign to Japan and that their adoption is unlikely to improve corporate performance.¹⁹⁸

¹⁹⁴ Poe et al., *supra* note 4, at 74. Keidanren is the most influential business organization in Japan, and is known to be very conservative. *Id.* Traditionally, it has been dominated by Japanese Big Business and has opposed reform measures that might provide greater external control. *Id.*

¹⁹⁵ Takahashi, *supra* note 128, at 9 (indicating that one of *Keidanren's* proposals was to strengthen the auditor system by increasing the number of auditors and establishing new requirements designed to ensure auditor independence).

¹⁹⁶ *Id.* at 9-10 (indicating that one such proposal was to provide that a majority of auditors be outsiders and that each auditor's term of office be extended).

¹⁹⁷ See, e.g. Goldstein, *supra* note 3 (indicating that Toyota is widely viewed as one of Japan's most traditional "Japanese" firms).

¹⁹⁸ See Nikkei Global Management Forum, *Are Western Methods the Solution?* (July 11, 2002), at <http://nni.nikkei.co.jp/fr/Nikkei/ngmf/ngmf99/ngmf009.html> (last visited Jan. 5, 2003); see also David Ibson, *U.S. Scandals Go Down Well in Japan: Lauded Business Model Now Shown to be Flawed*, FINANCIAL TIMES, Aug. 15, 2002, at 12 (quoting Osaka Mayor Takafumi Isomura as saying "You must do things the proper Japanese way" in response to causes of a scandal in connection with Universal Studios' Osaka theme park).

3. *Persistent Cultural Norms Will Limit the Amendment's Effectiveness*

For those companies that do opt for the executive officer system, cultural norms still threaten its effectiveness. Even though the Amendment creates the executive officers as a separate corporate organ, a continuing corporate emphasis on hierarchy within the "company community"¹⁹⁹ threatens to undercut its potency. To the extent that most executives continue to be promoted from within the corporation,²⁰⁰ it is likely that the chief executive will retain the penultimate corporate powers of the former representative director. Even if the chief executive is no longer titled "representative director" but remains the functional equivalent, it is likely that the unchecked power associated with that position will persist. Thus, there may be a shifting of titles for corporations adopting the new system without a genuine shift in practice.

Analysis of Sony's reforms from a different perspective indicates that the Amendment may induce only cosmetic corporate governance changes and mask persistent Japanese cultural traits of hierarchy and community that limit their impact.²⁰¹ The supposedly improved oversight of Sony's board continues to serve as a rubber stamp for the decisions of the inside director majority, which sets the agenda in closed door meetings.²⁰² Indeed, as of July 1999, no item proposed by that group had been rejected by the full board.²⁰³ As Sony President Nobuyuki Idei explained, "the management meetings and the board of directors do not raise different opinions."²⁰⁴ Similarly, the fact that Sony merely shifted former directors to executive officer positions²⁰⁵ indicates that they retained their hierarchical roles and remained subordinate to the representative director. A ten-member board dominated by insiders supervising thirty-seven insider executives hardly instills faith in shareholders that it will not be beholden to the interests of its individual members.

¹⁹⁹ See generally, Shishido, *supra* note 63 (arguing that an informal company community based on individual relationships and hierarchy actually govern and discipline the modern Japanese corporation).

²⁰⁰ See KONO, *supra* note 80 and accompanying text.

²⁰¹ Takahashi, *supra* note 128, at 7.

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.*

4. *The Recent Wave of American Corporate Scandals Will Limit Adoption of the Executive Officer System*

The recent spate of American corporate scandals has also renewed distaste for American forms of business management.²⁰⁶ American executives such as Enron's Kenneth Lay, WorldCom's Scott Sullivan, and Global Crossing's Gary Winnick, together received over US\$ 750 million while managing their companies into bankruptcy.²⁰⁷ These executives are part of a larger corporate heist in which the senior executives and directors of the twenty-five biggest business collapses between 1999 and 2001 walked away with US\$ 3.3 billion in salary, bonuses and proceeds from the sale of stock options.²⁰⁸ Some Japanese business leaders have seized upon these events as evidence that the American system is no better than Japan's at preventing corruption and delivering shareholder value.²⁰⁹ They are prompted to question why Japan would want to adopt a system susceptible to such horrendous abuse.

These arguments misconstrue the issue and ignore Japan's own shortcomings. The goal of Japan's corporate governance reform is to restore economic prosperity and international competitiveness.²¹⁰ Installing systems that improve oversight are in the best interests of Japanese corporations and the global market economy overall.²¹¹ Although America's corporate governance shortcomings are undeniable, it is conceptually among the most transparent and accountability-oriented in the world,²¹² and, unlike Japan, the United States has moved swiftly to install corporate mechanisms designed to improve accountability and oversight.²¹³ The real question Japanese business leaders should be prompted to ask is if such scandal can occur in America, what action can we take to improve our own system?

VI. CONCLUSION

Ultimately, the Amendment's impact will be a function of how individual Japanese corporations view their role in an increasingly global economy. Japanese firms now empowered by the Amendment to legally

²⁰⁶ Goldstein, *supra* note 3.

²⁰⁷ Cassidy, *supra* note 52, at 1.

²⁰⁸ *Id.* at 2.

²⁰⁹ Goldstein, *supra* note 3.

²¹⁰ Hashimoto, *supra* note 151, at 10.

²¹¹ Witherell, *supra* note 132, at 8.

²¹² *Id.* (expressing doubt about how effective the system is in practice as opposed to "on paper").

²¹³ See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

adopt an American-style executive officer system or to retain the conventional Japanese system must decide for themselves which corporate governance model will best serve their needs in the global economy.²¹⁴

Firms that compete for investor capital directly in various markets are most likely to adopt the Amendment. To attract investors, these firms must present themselves as a sound investment not only from a purely financial perspective but also by demonstrating that their corporate governance practices are transparent, efficient, and accountable.²¹⁵ To this end, the Amendment's option to adopt an American-style executive officer system provides the basic structure with which a firm can establish effective corporate governance. Although the Amendment faces many obstacles,²¹⁶ it provides an option for Japanese firms to implement the system, adjust it to a Japanese context, and cultivate a commitment to accountability and shareholder interest. To the extent adopting firms promote these values, they may percolate throughout corporate groups and industries and serve as a catalyst for more widespread change.²¹⁷

Conversely, firms who remain insulated by their main bank or who are otherwise less dependent on competing for foreign capital are more likely to retain the modified conventional system. If, in fact, firms adopting the new system do succeed while conventional firms do not, an incentive may emerge to adopt the system. Perhaps too, Japanese firms retaining the conventional system will find extralegal methods of creating functional oversight and improved decision-making.²¹⁸

For both of these groups, real barriers to effective implementation exist.²¹⁹ The optional nature of the Amendment, strong preference for Japanese business practices, the persistence of corporate norms emphasizing hierarchy and community, and renewed suspicion of American corporate institutions all stand as obstacles to systemic corporate governance reform. But as the history of the American corporate law demonstrates, systemic reform frequently takes time. From this perspective, the Amendment serves as one of the first key steps taken by Japan to reform its corporate governance practices, and to that end, it is a reason to be optimistic that more change is on the horizon.

²¹⁴ Hashimoto, *supra* note 151.

²¹⁵ Poe et al., *supra* note 4, at 79.

²¹⁶ See discussion *supra* Part IV.B.

²¹⁷ Michael Solomon Associates, Inc., *supra* note 90, at 4.

²¹⁸ Milhaupt, *Relational Theory*, *supra* note 20, at 4-9.

²¹⁹ See discussion *supra* Part IV.B. and accompanying notes.

