THE JAPANESE INDEPENDENT DIRECTOR MECHANISM REVISITED: THE CORPORATE LAW SETTING, CURRENT STATUS, AND ITS EXPLANATIONS

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I. INTRODUCTION

Japanese corporate governance or, broadly speaking, "Japanese capitalism," traditionally possessed several distinct attributes. The most often-mentioned attributes include a powerful bureaucracy, close ties between government and industry, a central banking system, lifetime employment, and dense inter-firm networks. Japanese capitalism also relies on many long-term relationships between employees, banks, suppliers, other firms and even the government. These attributes of the Japanese model deviate from the typical industrial capitalist system, the Anglo-American style of corporate governance.

However, Japanese corporate governance has been changed to more closely resemble the Anglo-American style silently. Following the 1980s frenzy of Ezra Vogel's *Japan as Number One: Lessons for America*[1] and the end of Japan's economic "miracle," recession ensued in the 1990s.[2] As a result, an increasing number of questions have arisen regarding the relationship between the initial strength and subsequent weakness of Japanese corporate governance. In the quest to reverse the downward trend, policy reform was initiated, and many new rules were implemented, dramatically changing the landscape of Japanese corporate governance. However, the result of these reforms is still unclear.

Several elements comprise the reform and make a more detailed examination of specific rules fundamental to understanding the way Japanese corporate governance has changed and the direction in which it is headed. The institution of the independent director is among the many new reforms in Japan, and its introduction is both understandable and puzzling. On the one hand, it is a response to the long-criticized corporate governance system that is mostly controlled by insiders and lacks oversight capabilities. The urgency for reform became more apparent during the economic malaise of the 1990s. By the late 1990s, momentum was building for a complete overhaul of the traditional corporate governance model, and the independent director, considered to be a distinctive characteristic of American corporate governance, was the chosen cure. On the other hand, this move was puzzling, because the independent director contradicts most of the values inherent in Japanese corporate governance; the values which paved the path to Japan's economic success after World War II. The decision to import the independent director mechanism highlighted the contrast between traditional Japanese rules and Anglo-American corporate governance.

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1. EZRA F. VOGEL, JAPAN AS NUMBER ONE: LESSONS FOR AMERICA (Harvard Univ. Press 1979).

2. For a detailed description of the macroeconomic situation Japan experienced in this period, see *generally* HIROSHI YOSHIKAWA, JAPAN'S LOST DECADE (Charles H. Stewart trans., The Int'l House of Japan 2002) (1999).

In general, the series of amendments to Japanese corporate laws made in the 1990s and early 2000s took two approaches: deregulation meant to reinvigorate corporate energy, and enhancement of monitoring capabilities designed to curb corporate misconduct.[3] Though conceptually distinct, both approaches sometimes pointed to a more Anglo-American-style governance system as the solution to the growing concerns regarding Japan's economic viability.

Legislative materials show that the independent director mechanism was expected to facilitate enhanced monitoring. This addition is the latest in a series of amendments to Japanese corporate law since the 1970s that reinforce monitoring to discourage corporate misconduct. Support for adopting the independent director mechanism grew in 2002 as the desire for Anglo-American-style governance reached its peak and the confidence in Japanese corporate rules dropped to its lowest level.

This article will explore the introduction of Anglo-American-style elements as reform, including the committee structure within a single board, the introduction of the independent director mechanism in 2002, and the success of these changes. Part II of the article lays out the necessary background concerning Japanese corporate law since World War II, including its basic organizational rules, amendments since the 1990s, and the reasoning behind these changes. Part III focuses on the evolving corporate structure, including the changing function of corporate auditors, the newly created committee structure, and ultimately the adoption of the independent director mechanism. It concludes with a discussion of the conception, implementation, and current status of the independent director mechanism in Japan.

Part IV then analyzes the reasons this new institution has encountered difficulty in Japan and discusses the possible dynamics that will shape its future. After reviewing the normative grounds for board independence and the need for a simpler governance structure, this article argues that a more extensive use of the independent director mechanism in Japan would better meet the demands of a fast-changing environment. Part V concludes.

II. JAPANESE COMPANY LAW: PAST AND PRESENT

A. A Brief History of Japanese Corporate Law Before the 1990s

Legal transplants are not new to the design of Japanese corporate governance. Historically, the law that governs corporate governance in Japan was almost entirely imported. The first generation of Japanese corporate law, the Commercial Code (Shŏhŏ), supplied the basic rules for corporate formation and conduct; it was originally based on Germany's model and imported during the end of the

3. Curtis J. Milhaupt, *A Lost Decade for Japanese Corporate Governance Reform?: What's Changed, What Hasn't, and Why*, INSTITUTIONAL CHANGE IN JAPAN 97, 98 (Magnus Blomstrom & Sumner La Croix eds., 2006), *available at* http://ssrn.com/abstract=442960.

nineteenth century.[4] After World War II, American influence became the most important factor shaping the landscape of Japan's corporate law.

The Commercial Code was originally adopted in 1899, and part of the Code still remains in effect today. The 1899 version was modeled after the German Commercial Code (Handelsgesetzbuch) of 1897.[5] Japan's Commercial Code of 1899 was its primary source of corporate law until 2005. The Code was divided into five parts: General, Company, Commercial Transaction, Merchant Shipping and Insurance.[6]

The second generation of Japanese corporate law emerged after World War II by way of amendments to the Commercial Code. U.S. authorities extensively modified the Commercial Code during the occupation of Japan as part of an agenda to reform the political and economic structure.[7] In 1950, Part II of the Commercial Code, pertaining to Company Law, was amended with several important changes. The powers of directors were both expanded and contracted, altering the balance of power between directors and shareholders. Before World War II, shareholders could directly intervene in the management of companies in many scenarios, and directors had to be shareholders. With the creation of the board of directors, the managing power was more clearly assigned to the board, and the separation of management and ownership was established. Thus, the directors' power expanded.

In addition, shareholders' rights were strengthened so that they could exercise control over the management of the company: as directors were elected by the

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4. HIROSHI ODA, JAPANESE LAW 131 (2d ed., Oxford Press 1999) (1992).

5. *Id.* The Commercial Code of Japan was first promulgated in 1890. It was based upon a draft prepared by a German adviser, Herman Roesler, who consulted German, French, and English law in the course of its preparation. The composition of the Commercial Code was similar to that of the French Commercial Code of 1807, although in substance it could be described as a blend of German and French law. However, that version of the Commercial Code was met with a flurry of criticism, which delayed its enactment.

6. *Id.* Part II of the Commercial Code, Company Law, covered joint stock companies as well as general partnership and limited partnerships. *Id*. There was a separate law for limited liability companies (the Limited Liability Company Law). *Id.* at 131, 216. Before World War II, company law in Japan was under strong German influence, and the predominantly German characteristics helped to set up modern business regulation and an environment in which family-owned business (*Zaibatsu*) successfully thrived. For a detailed account of the history of Zaibatsu and how it shaped modern Japanese economy before World War II, see HIDEMASA MORIKAWA, ZAIBATSU: THE RISE AND FALL OF FAMILY ENTERPRISE GROUPS IN JAPAN (Univ. of Tokyo Press 1992).

7. For a general account of the role that U.S. had in restructuring Japanese political economy in the post war period, see WILLIAM K. TABB, THE POSTWAR JAPANESE SYSTEM: CULTURAL ECONOMY AND ECONOMIC TRANSFORMATION, 86-111 (Oxford Univ. Press 1995) (discussing how keiretsu, industrial relations system, political governance, and bureaucratic guidance institutions were formed in the that period); Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture and the Rule of Law*, 37 HARV. INT'L L.J. 3, 15 (1996) (As a result of the U.S. occupation, Japanese securities law is modeled after the federal securities law of the United States).

shareholders to serve as the governing unit of the corporation,[8] and director liability increased. Therefore, during the post-war reform, institutions popular in the United States were introduced into Japan's primarily German framework, both expanding and contracting the power of corporate directors vis-à-vis shareholders.[9]

Part II (Company Law) of the Commercial Code has undergone a number of major amendments since 1950, many of which were in response to developments in U.S. corporate law and practice. Two important amendments, introduced in 1974 and 1981, addressed audit requirements, financing matters, and shareholders meeting administration.[10] Many of these corporate law amendments were the result of strong U.S. influence, stemming from increasingly close economic ties between the United States and Japan. The 1990s and early 2000s witnessed the rapid adoption of amendments reflecting this influence.

B. Amendments from 1990 through the Adoption of the Companies Act of 2005

Although several amendments were made during the 1970s and 1980s, the frequency of Commercial Code amendments increased substantially in the 1990s.[11] The major goals of these amendments were to enhance the protection of shareholders' rights and to strengthen monitoring of directors.

1. Enhancements to Shareholder Control

Shareholder power was expanded through various amendments to the Commercial Code. The amendments addressed the right of shareholders to inspect account books,[12] and side payments to shareholders as a means of ensuring smooth

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8. SHŌHŌ [COMMERCIAL CODE] art. 245, para. 1 (Japan) (directors are elected to the Board of Directors by the shareholders to serve as the governing unit of the corporation).

9. ODA, *supra* note 4, at 132. For a comprehensive introduction to German dual-board system, see generally Klaus J. Hopt, *The German Two-Tier Board: Experience, Theories and Reforms*, in COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 227 (Klaus J. Hopt et al., eds., 1998); Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe - Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, *in* VOC 1602-2004: 400 YEARS OF COMPANY LAW (Ella Gepken-Jager et al., eds., 2005).

10. In 1974, the Law on Special Measures to the Commercial Code on Audit and Related Matters was enacted and differentiated the level of auditing requirements according to company size and enhanced auditing rules for large companies. In the 1981 amendment, the focus was on removing restrictions related to financing matters and the audit system. This 1981 amendment was also concerned with regulations on shares, improvements in the administration of the annual general meeting of shareholders, and strengthening the power of the board of directors at the expense of individual directors' power. It should be noted that the issuing of warrant bonds was made possible by this amendment. ODA, *supra* note 4, at 217.

11. For an introduction to the amendments to the Commercial Code in the 1990s and after, see generally HIDEKI KANDA, KAISHA HO [COMPANIES ACT] 31-37 (11th ed. 2009).

12. COMMERCIAL CODE AMENDMENT OF 1993, Act No. 62 of 1993. All amendments of the Commercial Code are incorporated as part of the whole text when passed, and the original articles are removed. In addition, unless otherwise noted, mentioned changes all remain current.

and speedy shareholders meetings were prohibited.[13] Reforms also included the loosening of the quorum requirement and related procedure of the shareholder's special meeting and revised rules concerning the right to vote on the election of directors and corporate auditors by classified shareholders.[14]

2. The Role of the Corporate Auditor/Board of Corporate Auditors

Amendments were issued in 1993 and 2001 pertaining to corporate auditors. The amendments extended the term of service for corporate auditors to four years.[15] A company that qualifies as a "large company,"[16] is required by to have more than three corporate auditors; it must form a "board of auditors,"[17] half of which must be "outside auditors."[18] In addition, the qualifications of outside corporate auditors were tightened.[19] These changes alleviated the liability of directors and auditors by setting a cap on the amount of damages under certain conditions. This cap is generally considered an attempt to pacify the anger of the business community caused by an increasing number of shareholders' derivative suits since the mid-1990s.[20]

The fee for filing a derivative suit was reduced to a flat 8,200 Japanese yen if the target of litigation did not exceed 950,000 yen (In 2003, the numbers changed to 13,000 yen and 1.6 million yen respectively). If the target of litigation is not monetary damage, which comprises most of the derivative suits in Japan, the lowest filing fee (currently 13,000 yen) applies. This substantially lowered the threshold for shareholders to bring derivative suits. Further, the qualification for requesting to review accounting materials and books was lowered from holding more than ten percent of the outstanding shares to three percent.

13. KANDA, *supra* note 11, at 32.

14. *Id.* at 33.

15. *See* KAISHA HO [COMPANIES ACT], Act No. 86 of 2005 [hereinafter COMPANIES ACT], art. 336, para. 1. The term of corporate auditors was extended from two to three years in 1993 and from three to four years in 2001. COMMERCIAL CODE AMENDMENT OF 1993, Act No. 62 of 1993; COMMERCIAL CODE AMENDMENT OF 2001, Act No. 149 of 2001.

16. Companies with more than 500 million yen in capital and twenty billion in liability are classified as "Large Companies." COMPANIES ACT, *supra* note 15, art. 2, para.. 1.

17. KANDA, *supra* note 11, at 219; *see also* COMPANIES ACT, *supra* note 15, art 328, para. 1.

18. COMPANIES ACT, *supra* note 15, art 335, para. 3. In literal translation, the word used in Japanese statutes is "outside (*shagai*)" rather than "independent (*dokuritsu*)" in referring to independent directors and independent auditors. However, as these terms are often used interchangeably both in English and Japanese, hereinafter "independent director" will be used as the English translation for "shagai torishimariyaku (outside director)" in Japanese. However, some scholars argue that there are some differences between the uses of independent, outside, and disinterested directors. *See generally* Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73 (2007) (arguing that these manifestations serve different purposes and should not be confused with each other). The law now requires the majority of corporate auditors in the board of corporate auditors to be outside corporate auditors.

19. For a more detailed discussion of the function of a corporate auditor, its relationship with the independent director, and what these amendments mean to Japanese corporate governance structure, *see infra* Parts II.C.4, III.A.1, IV.

20. KANDA, *supra* note 11, at 33.

3. Changing Controls on Corporate Stocks and Bonds

The 1993 Amendment overhauled the rules concerning corporate bonds and removed the limit on the number of corporate bonds a company can issue.[21] In 1994, company power to purchase its own shares was liberalized.[22] The litany of amendments continued with 1997[23] amendments to introduce stock options and a simplified procedure for mergers; side payments to shareholders were also prohibited.[24] In 1999, a stock swap mechanism was introduced.[25] This mechanism was the result of lifting the ban on holding companies in the Anti-Monopoly Law of 1997,[26] which allowed companies to surrender all of their shares and become a subsidiary of another company.[27] It was considered a further step towards liberalization of corporate mergers and acquisitions.

In 2000, rules concerning corporate division and stock options were amended and rules concerning the short form asset transfer were also introduced.[28] Notably, irregular transactions between parent and subsidiary, especially those without reasonable consideration, were prohibited. Companies were permitted to acquire their own shares free of any conditions, and rules concerning the basic unit of shares and their face value were repealed.[29] The process of issuing shares was also further simplified in this amendment.[30] The November 2001 Amendment further liberalized the issuance of classified stocks and allowed issuance of shares with limited voting power, along with other rules on exercising convertible bonds and issuing new stock for a specific third party.[31] It also stipulated to the use of electronic format in corporate bookkeeping, notification, and voting by directors.[32]

In 2002, the Commercial Code was again extensively amended.[33] The most important change was the introduction of the one-board structure (hereinafter the

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21. *Id.* at 32.

22. COMMERCIAL CODE AMENDMENT OF 1994, Act No. 66 of 1994. In this amendment, companies are allowed to acquire their own shares if those shares are acquired for distribution to its directors and employees, to eliminate them according to a resolution of the shareholders' meeting, or based on the request of a shareholder in companies in which the transferability of shares is limited. This power was further liberalized in 2000. *See infra* text accompanying note 29.

23. COMMERCIAL CODE AMENDMENT OF 1997, Act No. 56, 71, and 107 of 1997.

24. COMMERCIAL CODE AMENDMENT OF 1997, Act No. 107 of 1997; *see also* KANDA *supra* note 11 at 32 (side payments to ensure the smooth operation of shareholders meetings were prohibited).

25. COMMERCIAL CODE AMENDMENT OF 1999, Act No. 125 of 1999.

26. *Id.*

27. *Id.*

28. COMMERCIAL CODE AMENDMENT OF 2000, Act No. 90 of 2000.

29. COMMERCIAL CODE AMENDMENT OF 2001, Act No. 79 of 2001.

30. KANDA, *supra* note 11, at 32.

31. COMMERCIAL CODE AMENDMENT OF 2001, Act No. 128 of 2001.

32. KANDA, *supra* note 11, at 32-33.

33. COMMERCIAL CODE AMENDMENT OF 2002, Act No. 44 of 2002.

"Committee Structure Company").[34] The law concerning short-term corporate bonds was amended and expanded to cover all corporate bonds.[35] The Amendment also expanded the rules of asset evaluation, alternative forms of capital infusion, reducing capital, and altered the relevant trading rules extensively.[36]

In 2003, reform limited companies' ability to buy back their own stock; companies were permitted to buy back their own stock only if the board of directors approved the purchase through a resolution and if the authority to do so was previously stipulated in the company's articles of incorporation.[37] In 2004, rules concerning the use of electronic bulletin systems to publicize information were provided. Companies were encouraged to make stocks and corporate bonds electronic.[38]

4. The Companies Act of 2005

All the amendments above were part of a larger agenda. After many years of thought and deliberation, the Japanese Cabinet submitted the Companies Act to congress in 2005, replacing the Company Law section of the Commercial Code and other related legislation.[39] The voluminous Companies Act, along with the supplementary rules concerning its implementation, is designed to integrate, reorganize and consolidate all the legislation in the area of corporate law that had been produced since the World War II. Ideally, the law as a while could become more comprehensive if the differences in legislation were coordinated.[40]

In addition to the desire to improve the organization of the legislation, a primary goal of the Companies Act of 2005 followed the line of reasoning which started from the late 1990s: enhancing flexibility and providing more mobility for business management.[41] In order to encourage corporate reorganization and mergers and acquisitions, procedures and rules were simplified.[42] Moreover, to facilitate corporate capital raising, the rules were modified to allow management more discretion and flexibility in issuing corporate bonds.[43] Regarding the type of

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34. For more detailed information about the Committee Structure Company, see *infra* Part III.B.1.a.

35. AMENDMENT OF CORPORATE BOND EXCHANGE AND TRANSFERAL LAW, Act No. 65 of 2002.

36. *Id.*

37. COMMERCIAL CODE AMENDMENT OF 2003, Act No. 132 of 2003.

38. KANDA, *supra* note 11, at 34 (discussing rules supplemented).

39. COMPANIES ACT, *supra* note 15 (replacing Part II of the Commercial Code, pertaining to Company Law). The Companies Act was promulgated in July 26, 2005 and most of its eight parts and 979 articles came into effect in May 2006. The part concerning versification of the forms of mergers became effective in May 2007. The Japanese Cabinet Secretariat provides an English translation of this and other laws on its website. Japanese Law Translation homepage, http://www.japaneselawtranslation.go.jp (last visited Apr. 17, 2010).

40. KANDA, *supra* note 11, at 34-35.

41. *Id.* For the detail about accounting advisor, see *infra* Part II.D.5.

42. *Id.* at 35.

43. *Id.*

company, the new Companies Act repealed the minimum capital requirement and integrated the limited company and the stock company into a single form (hereinafter the "Stock Company"); it also repealed the minimum capital requirement. The Companies Act added limited partnership to the menu of companies.[44] To improve the quality of business management, the rules governing derivative suits were revised and a lower liability standard was applied to directors in derivative suits.[45] Rules were promulgated concerning accounting advisors to improve accounting accuracy.[46]

The Companies Act of 2005 is part of a continuous endeavor to change the highly regulatory style in the Japanese economic landscape. It stresses the need for management to have the power to deal with the challenge of increasing global competition and the aftermath of the long economic malaise in the 1990s.

There are still many unresolved conflicts. For example, narrowing the rules for derivative suits is rooted in managers' desire for larger safe zones in the face of the general trend of deregulation. At the same time, new rules about accounting audits highlight the fact that corporate misconduct is still a major concern.[47] The current solution (i.e., the amended legislation outlined *supra*) reflects the preference for setting up new corporate organs through Japanese corporate legislation.[48] Reliance on organizational rules faces both support and opposition in Japan, raises complex questions regarding the role of the organizational design in the law and whether any change created should take a mandatory or voluntary approach.[49]

C. Behind the New Rules: Changes in the 1990s

To understand the vicissitude of Japanese corporate law, it must be observed not only from a legal perspective, but also in the economic and political contexts in which it was enacted. It is generally believed that the great frequency of amendments to the Commercial Code (especially regarding Company Law) was a response to the challenges of the economic depression in the 1990s. The prolonged economic malaise complicated the task of reform and made it difficult to evaluate the efficacy of these amendments, both on their face and in substance. Only by observing the background of these changes can the overhaul of corporate law, the creation of the Companies Act, and their meanings be understood.

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44. *Id*.

45. *Id*. at 35, 228-29 (lowering the standard down from strict liability).

46. *Id*. at 35.

47. This kind of contradiction is commonly shared in many Japanese reforms from the 1990s on. *Cf.* John O. Haley, *Heisei Renewal or Heisei Transformation: Are Legal Reforms Really Changing Japan?*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=825689 (Using election law, legal education and corporate governance as three examples to examine the general problems encountered by various legal reforms in Japan since the 1990s.).

48. *See e.g.*, *infra* Parts II.D.4, II.D.5.

49. For a more detailed discussion concerning the debate surrounding the adaptation of new corporate organizational design in Japan, see *infra* Parts III.C, IV.C.

1. The Economic Bubble in the 1990s

From the end of World War II until the 1980s, Japan, in many respects, displayed tangible signs of success: rapid economic growth, a rising standard of living, booming exports, technological leadership, and financial power.[50] Japan performed well across a broad range of social indicators, including high educational achievement, excellent health standards, low crime rates and little income inequality.[51] By the 1980s, even the modest Japanese people had developed a certain confidence and pride in their economic system.[52]

This unprecedented economic success erupted in a moment of market euphoria in the late 1980s—now referred to simply as "The Bubble"—in which investors poured money into real estate and stock markets.[53] When the bubble finally burst in 1991, Japan descended into a prolonged economic decline that led to a decade-long economic stagnation.

The burst of the economic bubble presented a complex challenge for Japan's economy, the second largest economy in the world at the time, and resulted in various changes. Challenges confronted the very institutions and culture that had been credited with Japan's past success, such as a powerful bureaucracy, close government-industry ties, lifetime employment, a central banking system and dense inter-firm networks.[54] After several futile attempts to end the lasting economic malaise, the range of reforms expanded beyond economic measures to change the design of the institutions that drive the economy, such as industrial organizations, law, and government; and to alter the behavior and psychology of institutional actors.[55]

2. Changes to the Corporate Landscape

The stagnant economy of the 1990s and early 2000s provided an opportunity, and strong incentives for Japan's business world to examine old business patterns, creating fertile ground for the development of a new mode of corporate thinking, behavior and governance structure.

Several important changes in the economic landscape occurred during this period, which had a substantial impact on Japanese business circles and corporate law. For example, *Keiretsu* (corporate conglomerates) started to dissolve,[56] and

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50. STEVEN K. VOGEL, JAPAN REMODELED: HOW GOVERNMENT AND INDUSTRY ARE REFORMING JAPANESE CAPITALISM 1 (Cornell Univ. Press 2006) [hereinafter JAPAN REMODELED].

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. For a general introduction of *Keiretsu* and its meaning to Japanese corporate governance, *see, e.g.,* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 879 (1993).

corporate cross-holdings declined.[57] Corporate reorganization became much more frequent and extensive.[58] Companies tried to reduce their reliance on banks and shift from indirect financing to direct financing.[59] Employment relationsbecame less stable and large-scale lay-offs challenged lifetime employment,[60] causing much uncertainty among the general public. Shareholder activism and derivative suits emerged.[61] The features that were once generally considered to be fundamental in Japanese corporate governance faced dramatic changes in the "lost decade" of economic stagnation.[62] By the end of the 1990s, Japan's economic picture had transformed, posing new questions about the validity of traditional understandings both in terms of law and society.

Some of the changes to Japan's economic landscape had the ability to affect the legal environment. The first and likely most important was the weakening of the corporate conglomerate (*Keiretsu*) and the reduction in cross-holdings among companies.[63] Horizontal *Keiretsu* helps companies provide preferential treatment to other companies within the same group and promoted cross-holding of each other's shares.[64] In general, it is done with a "main bank," which provides companies in the same group with credit at favorable rates and coordinates various capital flows.[65] In this system, the main bank also monitors member companies' performance.[66] In this way, companies kept a large proportion of their shares in stable hands, insulating them from other investors and eliminating the risk of hostile takeovers.[67] But since the reforms in the mid-1990s, the Japanese government has been pushing for the reduction of corporate groups.[68]

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57. For more discussion about the change of inter-company relationships, especially cross-holding, *see infra* Part IV.C.

58. *See infra* Part IV.C.

59. *See infra* text accompanying notes 71-72 and Part IV.B.

60. *See infra* Part IV.D.2.b.

61. *See infra* Part IV.D.2.e.

62. *See generally,* YOSHIKAWA, *supra* note 2 (providing a detailed description of the macroeconomic situation Japan experienced in the 1990s).

63. JAPAN REMODELED, *supra* note 50, at 9 (explaining that *keiretsu* vary in form, from vertically integrated suppliers and distributors to horizontally integrated industrial groups, and create relatively stable business relationships).

64. *Id*.

65. *Id.*

66. *Id.*

67. *Id.*; *see generally* MASAHIKO AOKI, INFORMATION, INCENTIVES, AND BARGAINING IN THE JAPANESE ECONOMY 127-49 (1988) (providing an in-depth analysis of the role of the "main bank"); THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES Part I (Masahiko Aoki & Hugh Patricks eds., 1994) (providing further depth on various aspects of the "main bank" system).

68. JAPAN REMODELED, *supra* note 50, at 9, 126-34. Traditionally, the main-bank system is widely perceived as the central character of Japanese corporate governance. However, this traditional view has been strongly challenged by Yoshiro Miwa and J. Mark Ramseyer in their recent literature. *See, e.g.*, Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC. INQUIRY 401, 401-02 (2002) (reviewing MASAHIKO AOKI, INFORMATION, CORPORATE GOVERNANCE, AND INSTITUTIONAL

Against the wave of weakening of amongst high-ranking corporate officers' authority, shareholders started to gain their say in corporate affairs. Increasing shareholder activism and the idea of shareholder primacy have started to gain a foothold, presenting an increasing challenge to Japan's long-standing management system.[69] On a practical level, this rarely resulted in any actual change in the distribution of power between management and shareholders. To the surprise of many observers, resultant shifts in power distribution have sometimes been contrary to their expectations: management demands more legal authority, claiming that it needs to retain power to deal with economic changes or remain competitive in keeping good people in the company.[70]

The psychological impact of the economic depression of the 1990s is another important consideration. In contrast to the economic boom in the 1980s, one of the most successful periods of economic growth since World War II, the 1990s brought a severe economic downturn. In this period, the Japanese people faced the erosion of lifetime employment and even massive layoffs in some industries, an unprecedented number of corporate failures, and a growing disparity between rich and poor.[71]

In spite of all of these challenges to "business as usual," and changes to the behavioral aspects of companies, the corresponding amendments in the Companies Act did not bring the benefits expected. This inevitably led to a more central and fundamental set of questions for corporate governance and to examine if all these amendments of law point to the wrong direction: Who runs the company and who should be responsible for decisions regarding the company? By what mechanism can we choose the right people to be in charge? And what is the best method to allocate and organize these people in an efficient and accountable way? In this sense, discussions of corporate governance in Japan, after the reforms of the 1990s, gradually relocated themselves to one of the most unpredictable aspects of corporate governance: the governance organs.

DIVERSITY: COMPETITIVENESS IN JAPAN, THE USA, AND THE TRANSITIONAL ECONOMIES (Stacey Jehlik trans., 2000) and arguing that the impact of the main-bank system and keiretsu on Japanese economy is limited and the relationship between the main-bank system and economic growth is also doubtful). *See also* Yoshiro Miwa & J. Mark Ramseyer, *The Fable of the Keiretsu*, 11 J. OF ECON. & MGMT. STRATEGY 169 (2002); Yoshiro Miwa & J. Mark Ramseyer, *Does Relationship Banking Matter?: The Myth of the Japanese Main Bank*, 2 J. OF EMPIRICAL LEGAL STUD. 261, 261 (2005); THE FABLE OF THE KEIRETSU: URBAN LEGENDS OF THE JAPANESE ECONOMY (2006).

69. Increasing presence of foreign institutional investors in Japan is considered as an important factor in this emerging "shareholder activism" wave. *See, e.g.*, Takaya Seki, *Legal Reform and Shareholder Activism by Institutional Investors in Japan*, 13 CORP. GOV. 377, 382-83 (2005) (noting foreign institutional investors such as the California Public Employees Retirement System and TIAA-CREF have been actively attending shareholders meeting, casting negative votes to proposals relating to payment of retiring directors and corporate auditors, and pushing for a heightened awareness of fiduciary obligation).

70. *See, e.g., supra* text accompanying note 34.

71. *See infra* Part IV.

D. The Basic Rules of the Japanese Corporate Governance Structure

Since the end of World War II, amendments to Japanese corporate law have kept pace with American corporate law. While both possess similar substantive rules forming its basic structure, there are still several differences, especially in terms of governance, structure and the role and function of the independent director. For example, the traditional Japanese company includes both a board of directors and board of corporate auditors, as opposed to the American model, which utilizes only a board of directors.[72]

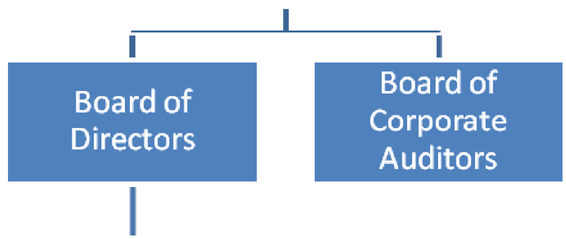

Chart 1: Simplified Version of the Japanese Traditional Two-Board Company

1. Types of Companies

The types of companies in the Companies Act include general partnerships (*goomeikaisha*), limited partnerships (*gooshikaisha*), limited liability companies (*goodookaisha*) and stock companies (*kabushikigaisha*).[73] General partnership companies, limited partnership companies and limited liability companies, collectively termed in Japan as "Membership Companies" or "Companies without Share," are all considered to have a strong membership flavor and are under various restrictions such as unlimited personal responsibility and limitation of investment transferability.[74]

72. COMPANIES ACT, *supra* note 15, art 2(i); *see infra* p. 81.

73. *Id.*

74. Because those features mentioned, these three types of companies will be generally excluded in the following discussion and stock company will be the main organizational form when referring to "company" or "corporation" in the following text.

This article will focus on those companies that issue stocks, referred to as "public companies" in the Companies Act.[75] Companies whose stocks are traded in stock exchanges are termed "publicly traded companies."

2. Shareholders Meeting

The power of the shareholders meeting in Japan depends on whether or not a stock company forms a board of directors. According to Article 295 of the Companies Act, for companies that do not form a board of directors, the shareholders meeting is empowered to make any decision concerning the management of the company, including organization, operations and administration.[76] For companies choosing to form a board of directors, however, the shareholders meeting's power will be dramatically limited to those items stipulated in the Companies Act and in individual companies' articles of incorporation.[77] In such cases, shareholders meetings generally do not have authority to be involved in the general management of the company. In practice, as most companies of certain size opt to form a board of directors, the shareholders meeting in Japan is at best an organ for broad corporate decision-making, lacking the power of execution.[78] Despite the similarities between Japanese and U.S. corporate law, the actual practice of shareholders in Japan differs remarkably from the United States, particularly in that they rarely seek judicial enforcement of fiduciary duties.[79]

According to the Companies Act of 2005, shareholders meetings empower shareholders to vote on the election and termination of directors and corporate auditors[80]; vote on amendments to the corporate charter,[81] mergers,[82] divisions,[83]

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75. COMPANIES ACT, *supra* note 15, art 2(v) (defining a "public company" as "any Stock Company the articles of incorporation of which do not require, as a feature of all or part of its shares, the approval of the Stock Company for the acquisition of such shares by transfer").

76. *See id*. art. 295, para. 1.

77. *Id.* art. 295, para. 2.

78. According to the Companies Act, all public companies are required to form a board of directors. *Id.* art. 327 para.1, no. 1. Combining with article 295, when a stock company allows part or all its shares freely transferred, it has to form a board of directors and shift its management power to board of directors.

79. Traditionally, the derivative suit is not popular in Japan. According to Mark D. West, there were fewer than twenty derivative suits litigated in Japan between its introduction in 1950 and 1990. Mark D. West, *The Pricing of Shareholder Derivative Suits*, 88 NW. U. L. REV. 1436, 1438 (1994). However, the situation has gradually changed since the late 1990s. By the end of 1993, eighty-four cases were pending in Japanese courts. By 1996, that number rose to 174, and by the end of 1999, there were 286 such suits, including ninety-five filed in 1999 alone. CURTIS J. MILHAUPT & MARK D. WEST, ECONOMIC ORGANIZATIONS AND CORPORATE GOVERNANCE IN JAPAN 9 (2004). But the numbers stopped growing and steadily went down to slightly above one hundred in the period of 2000-2005. Tomotaka Fujita, *Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision*, in TRANSFORMING CORPORATE GOVERNANCE IN EAST ASIA 17 (Curtis Milhaupt et al. eds., 2008).

80. COMPANIES ACT, *supra* note 15, art 329, para. 1.

81. *Id*. art. 466.

82. *Id*. arts. 783, 795, 804.

dissolution,[84] distribution of dividends,[85] and merger of shares[86]; and make decisions in the event of conflicts of interest between directors and shareholders (e.g., the ratification of directorial compensation).[87] Although shareholders of companies with a board of directors are authorized through their meetings to decide only those matters provided for in the law or in the articles of incorporation, the items reserved for shareholders meetings through the Companies Act of 2005 are not subject to change by amendment to the articles of incorporation.[88]

Shareholders meetings are held annually,[89] although special meetings may be called from time to time.[90] The main purpose of the general meeting is to approve financial statements,[91] dividends[92] and the appointment of directors and corporate auditors.[93] Other than those items reserved to shareholders meetings, in general, the power to manage the corporation is allocated to the directors.

For a public company, shareholders meetings and the board of directors are mandatory elements. If companies do not make themselves public, by limiting all classes of shares freely transferred, they can choose to have only one or even several directors without forming a board of directors.[94] Under the Companies Act of 2005, however, all companies that create a board of directors must set up either a corporate auditor/board of corporate auditors or a committee structure with executive officers.[95] These organs have different rights and responsibilities regarding management of the company on behalf of the shareholders.

3. The Directors, Board of Directors and Representative Directors

Stock companies are generally managed by the directors acting together as a board of directors.[96] Those companies that choose not to form a board of directors must still have at least one director to carry out business management and represent the company.[97] Companies choosing not to form a board of directors can

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83. *Id*. art. 795-96.
84. *Id*. art. 471(iii).
85. *Id*. arts. 452-53.
86. *Id*. art. 180.
87. *Id*. art. 361, para. 2.
88. *Id*. art. 295, para. 3.
89. *Id.* art. 296, para. 1.
90. *Id.* art. 296, paras. 2-3.
91. *Id*. art. 438, paras. 1-2.
92. *Id*. art. 454.
93. *Id.* art. 329 para. 1; *see also id* art. 310 (allowing for voting by proxy, provided that the proxy is in writing and filed before each meeting).
94. *Id*. art. 326.
95. *See id*. art. 327.
96. *Id.* art. 362, para. 2(i) ("[The] [b]oard of directors shall . . . [decide] the execution of the operations of the Company").
97. *Id*. art. 326, para. 1.

still have multiple directors, and in this case, each director would have the power to represent his company and carry out business individually.[98]

A company can choose to limit the power of its directors to represent it by stipulating the limitations in its charter and delegating representative power to certain directors (called representative directors).[99] The remaining directors will then simply be "directors," and their power to represent the company would be limited by charter.[100] The difference between directors and representative directors mainly rests on the power to act on behalf of the company and in so acting, directly incur legal obligations on behalf of the company.[101] In this sense, although default rules in Japanese corporate law state that all directors have the power to represent the company (i.e., to make their acts directly incur legal obligation on behalf of the company represented), companies can, and generally do, opt out and limit this power to representative directors.[102]

In practice, most companies form a board of directors first, and then directors choose one or more representative directors from among themselves by resolution.[103] Each representative director can individually represent the company and is responsible for the day-to-day business of the company.[104] Representative directors have the power to either carry out decisions made by the board of directors, or to make decisions on their own, provided there has been no contrary decision made by the board of directors.[105] Directors who are not representative directors are not directly responsible for carrying out business, and their duties are mostly restricted to monitoring the company and its representative directors.[106] Thus, representative directors in fact dominate the running of company business, although non-representative directors can be delegated certain executive power by the representative directors or the board.[107]

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98. *See id.* art. 349, para. 2.

99. *Id.* art. 349, para. 1.

100. *Id*. art. 349, para. 3.

101. *Id.* art. 349, para. 4.

102. The representative director is generally the product of larger boards (ten or more directors, as is typical in Japan). Thus, a smaller group of directors is needed to increase the ability to make business decision efficiently and reduce the risk of misrepresentation. For example, Toyota Motor Corporation, the largest automobile maker in Japan, had twenty-nine directors on its board in 2010. Among the twenty-nine directors, nine directors are representative directors. *See* TOYOTA: Company > Company Profile > Board of Directors, http://www.toyota.co.jp/en/about_toyota/executives/index.html (last visited Mar. 25, 2010); Canon Inc., a leading office machines and consumer electronics manufacturer in Japan has twenty-five directors among which three are representative directors. *See* Canon: Corporate Info | Board of Directors, Auditors and Officers, http://web.canon.jp/corp/executive.html (last visited Mar. 25, 2010).

103. COMPANIES ACT, *supra* note 15, art 362, para. 2(iii).

104. *Id.* art. 363, para.. 1.

105. *Id.* art. 349, para. 4.

106. *See id.* art. 363, para. 4.

107. *Id.* art. 363, para.1(ii).

The Companies Act in this regard requires representative directors to report to the board at least once every three months[108] and excludes the power of representative directors from certain major transactions, which may substantially affect the company as a whole, such as the sale of an important asset or the appointment of important positions.[109] The board therefore retains the power to deliberate and decide on those major transactions. In addition, the company may impose restrictions to limit the representative director's authority.[110]

When directors are in disagreement in a company without a board of directors, the disagreement is solved by a majority vote of all directors.[111] When there is a board of directors, resolutions of the board of the directors can be adopted by a majority vote of the directors present in a board meeting.[112] At least a majority of the directors must be present to constitute a quorum.[113]

The duty imposed upon a director and the company is governed by the law relating to the mandate.[114] Directors have a duty to conduct the business of the company with a "good manager" standard of care, a higher standard than that expected when running one's own business.[115] Directors also have a duty to abide by the law, by the articles of incorporation and the resolution of the shareholders meeting, and to faithfully execute the business of the company.[116] Generally, Japanese courts and scholars agree that the duty to manage implies the concept of duty of care and the business judgment rule in American law, albeit with some variance.[117] Moreover, the duty to carry out business faithfully parallels the duty of loyalty in American law, as both require directors to place the company's interest above their own.

The function of the board of directors in Japan marks another key difference to the corporate organization common in the America. In theory, the board of directors in Japan is not only a managing unit, but also part of the monitoring unit.[118] "In actuality, the board of directors in Japan does not monitor the CEO,

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108. *Id*. art. 363, para. 2.

109. *Id.* art. 365.

110. *But see id.* art. 349(5) (disallowing such internal regulations from binding third parties acting in good faith, similar to the doctrine of apparent authority).

111. *Id.* art. 348, para. 2.

112. *Id.* art. 369, para. 1

113. *Id.*

114. *Id.* art. 330.

115. MINPŌ (CIVIL CODE), art 644.

116. COMPANIES ACT, *supra* note 15, art 355.

117. *See generally* KENJIRO EGASHIRA, KABUSHIKIKAISHA HO [LAWS OF STOCK CORPORATIONS] 428-30 (2008) (summarizing a long string of opinions from different courts and concluding that the majority of juridical opinions recognize a broadened discretion in considering whether a breach of duty of care has occurred); *but see* KANDA, *supra* note 11, at 203 (explaining that Japanese courts seem to extend to matters outside the core content of their judgment).

118. Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions,* 25 DEL. J. CORP. L. 189, 223 (2000).

rather the CEO monitors the board members."[119] This bureaucracy and CEO-centrism started to receive strong critiques after the economic bubble burst in the 1990s, and as a result, board structure gradually became a central issue in the series of corporate reforms since the 1990s.[120]

4. The Corporate Auditor and Board of Corporate Auditors

The corporate auditor (*Kansa-yaku*)[121] is the traditional Japanese corporate intra-organization designed to secure the fair and appropriate execution of corporate affairs. Large companies are obliged to appoint a board of corporate auditors unless the company is not public.[122] In forming a board of corporate auditors, at least three auditors and the majority of board members must be "outside corporate auditors".[123]

The most important function of the corporate auditor has been to monitor the propriety of the company's business practices. This includes, but is not limited to, monitoring all conduct of the directors or the board of directors in terms of the making and execution of corporate business decisions.[124] The idea of the corporate auditor comes originally from *Aufsichtrat* in German law, which Japanese law inherited in the late 19th century. Though it is also classified as a two-board system, the corporate auditor/board of corporate auditors in Japanese corporate law is different from the German *Aufsichtrat*.[125]

In Japanese law, although having the power to monitor directors and business practices, the corporate auditor is considered an "officer," as is a director. [126] Since both directors and auditors are elected by the shareholders as officers, they can be considered as parallel in authority.[127] As opposed to the hierarchical relationship in German law,[128] the Japanese corporate auditor plays a more

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119. *Id.* (resulting in most Japanese corporations maintaining a very conservative attitude toward the independent director or any individual, non-management director at all).

120. Not surprisingly, the independent director, as part of efforts to import American style corporate governance to respond to those critiques, began to have a greater presence in the Japanese corporate world in this period.

121. Other possible translations include: "Statutory Auditor," "Company Auditor" or "Auditor."

122. COMPANIES ACT, *supra* note 15, art 328, para. 1.

123. *Id.* art. 335, para. 3; *see also id.* art. 2 (xvi) (defining an "outside corporate auditor" as a person who has not been a past employee or director in the company in which he or she is serving or its subsidiaries. However, employees from parent companies are permitted, which is distinguishable from an independent director in the United States).

124. *See id.* art. 381, para. 1.a

125. *See* Hopt, *supra* note 9 and accompanying text (explaining the relationship between German and Japanese corporate structures).

126. *Id.* art. 329, para. 1.

127. *See id.*

128. *See* Hopt, *supra* note 9 (While in German law the *Aufsichtrat* has the power to appoint directors, and the composition of *Aufsichtrat* is a mix of the representatives of shareholders and employees, which is generally known as the "co-determination" mechanism. This means that the *Aufsichtrat* enjoys greater authority over directors than its counterpart in Japan.).

preventive, conservative and supplementary role in Japanese corporate law and in general perception.

The role of corporate auditor in Japan must be independent, and cannot be held by directors or employees of the same company (including its subsidiaries).[129] To ensure its independence, the term of the corporate auditor is four years and cannot be shortened by amending charter articles.[130] The scope of the corporate auditor's monitoring function has been the subject of fierce debates and frequent changes in Japan since its inception. The debate concerns whether corporate auditors are limited to monitoring just the legality of decisions made by the board of directors (or other managers when so permitted), or if the auditors can also review the propriety of those business decisions.[131]

Before confronting this gray area, which will be discussed in greater detail in Part III, it should be noted that the range of monitoring by corporate auditors generally includes ordinary business conduct and accounting, while leaving room for the discretion of directors' business judgment, which is not subject to review by corporate auditors. Corporate auditors are also required to make a monitoring report[132] and to share its contents at the annual shareholders' meeting.[133] Additionally, each corporate auditor, whether the company has formed a board of corporate auditors or not, can exercise his or her authority independently of other auditors.

5. The Accounting Advisor and Accounting Auditor

An accounting advisor's (*kaikei sanyo*) main function is, along with the directors, to produce all financial statements.[134] The accounting advisor must be a certified public accountant, an audit firm, a certified public tax accountant or a tax accounting company.[135] They enjoy the same two year term as the directors.[136] They are elected by the shareholders and are given the power to examine all of the

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129. COMPANIES ACT, *supra* note 15, art. 335, para. 2.

130. *Id.* art. 336.

131. This disagreement persists as both sides of this argument have its pitfall. If corporate auditors were allowed to conduct propriety monitoring, it would erode the principle that the board of directors are the ultimate corporate decision-makers and give corporate auditors excessive authority to intervene in every aspects of every corporate decision-making. Conversely, limiting the range of scrutiny to the legality issue would substantially limit the capacity of the corporate auditor and leave many of the decisions made by directors unchecked. In fact, since the corporate auditor is a parallel organ to the director in Japan, whether a corporate auditor can exercise his or her authority to look beyond the legality of business practices by directors or managers to the details of business management, and how to reconcile the disagreements which may occur between directors and corporate auditors, will inevitably become critical issues in the area of organizational design. In Japanese law, this is often described as the debate about "legality monitoring" versus "propriety monitoring." For further discussion, see *infra* Part III.

132. COMPANIES ACT, *supra* note 15, art. 381, para. 1.

133. *Id.* art. 384.

134. *Id.* art. 374, para. 1.

135. *Id.* art. 333, para. 1.

136. *Id.* art. 334, paras. 1-2.

company's accounting material, including when necessary, those materials belonging to the company's subsidiaries.[137] The accounting advisor bears the obligation to report any suspicious conduct to either the corporate auditors, or board of corporate auditors, or, if the company maintains neither, to the shareholders.[138]

Accounting advisors must also complete an "Accounting Advisor Report"[139] and attend board of directors meetings when the board reviews relevant financial statements.[140] The accounting advisor must also express his or her opinion in shareholders meetings when there is a disagreement with the directors regarding the approval of financial statements.[141] In short, though somewhat independent, the accounting advisor is considered to be an auxiliary organ to the directors to ensure better internal compliance in accounting affairs.[142]

The accounting auditor (*kaikei kansa jin*) and accounting advisor are functionally similar organs, but they work with different entities. The former works as an accounting specialist for the board of directors and the latter works with the corporate auditors and deals particularly with accounting audits. For large companies, as well as the Committee Structure Company, the accounting auditor is mandatory.[143] The accounting auditor is responsible for auditing all financial statements or relevant reports made by the internal accountants or accounting advisors and makes a report of his own.[144] In performing this duty, the accounting auditor also has the right to examine all the internal accounting books including those of the company's subsidiaries, if needed.[145] The accounting auditor also has the duty to report to corporate auditors if irregularities or illegalities are spotted[146] and must report in the shareholders meeting when he or she has disagreements with the corporate auditors.[147] Also, shareholders may request a presentation by the accounting auditor.[148]

Only certified public accountants and audit firms may be qualified as accounting auditors.[149] The accounting auditor serves a one-year term, and the

137. *Id.* art. 329, para. 1, art. 374, para. 3.

138. *Id.* art. 375, paras. 1, 2.

139. *Id.* art. 374, para. 1.

140. *Id.* art. 376.

141. *Id.* art. 377.

142. According to COMPANIES ACT, *supra* note 15, art. 2, para. 3, no. 4, the terms "Yakuin" (literally translated as "directorship") encompasses the director, corporate auditor and accounting advisor. Although they are elected by shareholders meeting too, accounting auditors are not classified as part of the "directorship." *Id.*

143. COMPANIES ACT, *supra* note 15, art. 327, para. 5; art. 328, para. 1.

144. *Id.* art. 327; art 396, para. 1.

145. *Id.* art. 396, paras. 2-4, 6.

146. *Id.* art. 397, paras. 1, 3.

147. *Id.* art. 398, para. 1.

148. *Id.* art. 398, para. 2.

149. *Id.* art. 337, para. 1.

shareholders elect the accounting auditor at the shareholders meeting.[150] The following diagram presents an extended version of the corporate organization for a traditional two-board company:

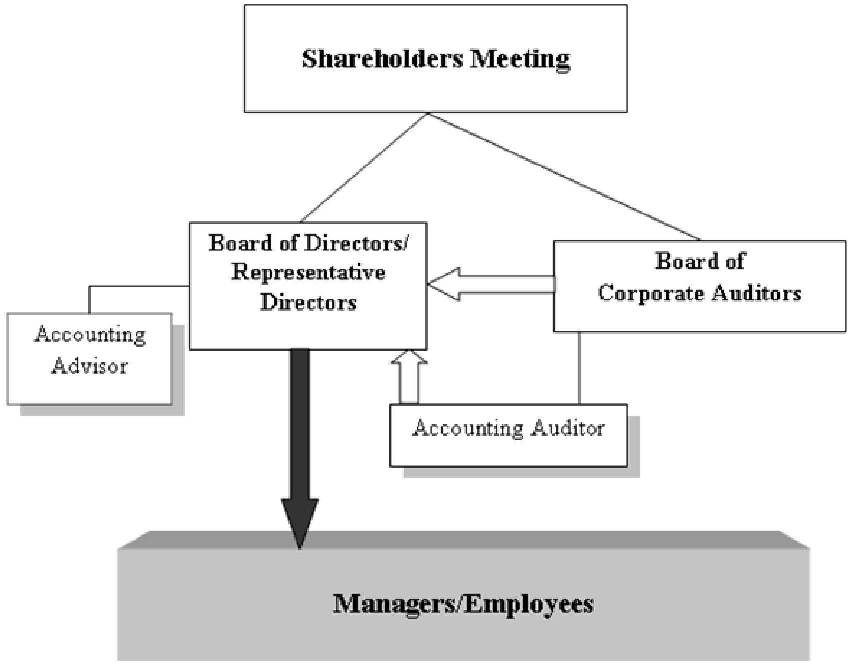

Chart 2: Corporate Structure of Traditional Two-Board Company (Extended Version)

Note: Arrow represents monitoring relationship, and dark arrow represents direct control

III. THE NEW RULE: CHANGING CORPORATE STRUCTURE AND THE INTRODUCTION OF THE INDEPENDENT DIRECTOR

A. The Constantly Changing Monitoring Mechanism in Japan: Corporate Auditors and the New Committee Structure Company

An examination of the change in the design of the corporate monitoring mechanism in Japan reveals the limits of the previous monitoring mechanism, the corporate auditor, and the feasibility of its replacement, the independent director.

150. *Id.* art. 338, para. 1; art. 329, para. 1.

1. The Corporate Auditor: Then and Now

In 1950, the second generation of corporate law was promulgated, and moved the corporate auditor from overseeing the board of directors to a parallel status. Before World War II, the corporate auditor had the responsibility of monitoring the directors' business conduct. After 1950, the responsibility of the corporate auditor diminished. As the board of directors gained more autonomy in corporate matters, most importantly the ability to issue corporate bonds and new shares, the representative director began to carry out daily business activities and the board of directors became the mechanism for monitoring the representative director. The power of the corporate auditor was limited to accounting and auditing affairs.[151]

This change in the structure of corporate responsibility caused several issues to arise. One concern was the monitoring function of the board of directors over the representative director. This was not a very effective monitoring mechanism since the representative director controlled the nomination of the board directors.[152]

To solve this problem, the Japanese Commercial Code was amended in 1974 to partially restore the range of the corporate auditors' monitoring to all aspects of directors' conduct, including business conduct other than that related to auditing. The application of the change was inconsistent. The Law on Special Measures to the Commercial Code on Audit and Related Matters required all large companies to set up accounting auditors and to thereafter accommodate the corporate auditor in their duties.[153] For those companies not designated as "large companies," the power of the corporate auditor was still limited to account auditing and did not include general business auditing.[154] The law also permitted companies to have multiple corporate auditors, and even allowed standing corporate auditors.[155] These changes reflected the need to reinforce the role that corporate auditors play in terms of internal monitoring.

Later, the term of the corporate auditor was extended to four years,[156] and large companies were required to have at least three corporate auditors, more than half of which needed to be outside auditors.[157] Additionally, the board of corporate

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151. LAWS OF STOCK CORPORATIONS, *supra* note 117, at 287.

152. *Id.* Another issue is that, per the *Securities Transaction Law,* adopted after World War II, companies traded on the stock exchange are required to retain a certified public accountant or auditing company to verify its accounting books and financial statements. In this sense, the auditing function of the corporate auditor is arguably redundant when the company is traded in on the stock exchange. *See also* KANDA, *supra* note 11, at 163.

153. Act No. 22 of 1974 (repealed in 2005).

154. LAWS OF STOCK CORPORATIONS, *supra* note 117, at 287; KANDA, *supra* note 11, at 163.

155. *Id.*

156. The 1993 Amendment extended the term of Corporate Auditors from two to three years, and the 2001 Amendment extended the term again, this time to four years.

157. The 1993 Amendment required three corporate auditors, at least one of which must be an outside auditor, not otherwise employed by the company or their subsidiaries; and the 2001 amendment increased the requirement to more than half.

auditors was introduced into law, and part of the auditing authority was transferred from the corporate auditor to the board of corporate auditors.[158]

Observing these historical developments, it is obvious that corporate auditing had been dominated by two simple realities: the ever-increasing need for more intensive monitoring to cope with the growing economic power of managers and directors and the disappointing fact that the corporate auditor in Japan has not functioned well enough to curb potential managerial misconduct. From the perspective of the legislation, the issue lying behind these amendments is the uncertainty legislators have about how to strike the right balance.

As generally recognized, the monitoring provided by corporate auditors is systematically insufficient, but legislators fear that a dramatic change of corporate power allocation will impair Japan's economic development pattern. Japanese companies are traditionally run by a group of highly professional, devoted managers, represented in the board of directors, which are mostly composed of senior managers who monopolize almost all the corporate power. Searching for a balance between "inadequate monitoring" and "excessive monitoring" led to a series of often well-intentioned but unfruitful reforms of the corporate auditor mechanism as a monitoring organ in Japanese companies.[159]

2. The Creation of the One-Board Company with Committees

Along with the many amendments that focused on the corporate auditor mechanism, the 2002 Amendment to the Commercial Code introduced a new board structure to Japan: the Committee Structure Company[160] (*iinkai-setsuchi-kaisha*).[161] The Committee Structure Company follows the single board structure adopted by most corporations in the United States and requires that the committees be composed of an independent director majority.[162]

Many Japanese academics and legislators believed the move toward an American-style board structure would effectively eliminate the dominance of the traditional two-tier board system in Japan. They also believed that this new structure would infuse new ideas and dynamics into the Japanese corporate environment, providing a chance to cure many of the old, flawed practices.

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158. *Id.*

159. This is not to say that there is no monitoring mechanism in Japanese companies. There is an effective and continuous monitoring mechanism among board members, in which monitoring is carried out in a hierarchical fashion by senior directors such as the CEO. However, this kind of monitoring cannot provide much use if senior directors are the ones who need to be monitored. For a discussion of how the concern of "inadequate monitoring" as the core issue led to the new amendments in 2002, *see infra* Part III.B.

160. For clarity's sake, this Article will use "Committee Structure Company" to mean the specific type of company created in 2002, and "committee structure" or "single board (with committee) structure" to mean the new governance structure applied in this kind of company in the following text.

161. *See* COMPANIES ACT, *supra* note 15, art. 2, para. 12. This term can be translated as "Committee Structure Company" or "Committee-Type Company."

162. *Id.*

B. The Two-Track System

1. The Independent Director Plus Committee Structure: Introduction

a. The Committee Structure Company and the Origin of the Independent Director

In the early 1990s, attention shifted from corporate auditors to the board of directors and its composition. This shift in focus began with the introduction of the independent director and requiring board members to be more independent. Hearing the voices from academia, the public and even other government agencies (including the Tokyo Stock Exchange) demand a more responsive and sound governance structure,[163] the Japanese Parliament began implementing an alternative corporate governance structure, and promoted the independent director mechanism as the answer to its problems.[164]

The 2002 Commercial Code Amendment introduced the Committee Structure Company in Japan. According to the legal definition in the Companies Act Article 2(12), a Committee Structure Company is a stock company that has a nominating committee, an audit committee and a compensation committee.[165] This rule creates a single board structure, which can be chosen at the company's discretion by amending the articles of the corporate charter.[166] In this new structure, a company can form a single board composed of directors, without any corporate auditors as members of the board and without forming a separate board of corporate auditors.[167] The board of directors then sets up committees as sub-organizations to perform different functions. Companies opting for the single board structure must establish: a nomination committee, an audit committee and a compensation committee, each of which must be composed of directors chosen by the board of directors.[168] There must be at least three members in each of these committees, and a majority of the members of each must be independent directors.[169]

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163. For example, The Tokyo Stock Exchange established a permanent corporate governance committee to advise the Exchange and listed companies in 2002. Tokyo Stock Exchange, Principles of Corporate Governance For Listed Companies, English version, *available at* http://www.tse.or.jp/english/rules/cg/principles.pdf (last visited June 13, 2010). In 2004, the Listed Company Corporate Governance Committee of Tokyo Stock Exchange issued "Principles of Corporate Governance for Listed Companies" as guideline to help improve corporate governance for all listed companies. For more information about the Listed Company Corporate Governance Committee of Tokyo Stock Exchange, *see generally id.*

164. The 2002 amendments to Japan's *Commercial Code* included a number of changes affecting the operation of boards of directors in Japan, including the notable introduction of the Committee Structure Company and its voluntary approach. *See infra* 2.b.

165. COMPANIES ACT, *supra* note 15, art. 2, para. 12.

166. *Id.* art. 326, para. 2.

167. *Id.* art. 326, para. 4.

168. *Id.* art. 400, para. 2.

169. *Id.* art. 400, paras. 1, 3. For companies adopting a committee structure, directors serve a term of one year rather than the two year term for directors in traditional structure companies.

Corresponding to the single tier board structure, the 2002 Amendment also introduced the executive officer (*shikkou yaku*) as a new corporate organ.[170] The executive officer is required in a Committee Structure Company, is elected by the board of directors and has the power to make daily business decisions. There may be one or more executive officers and, like the directors, each enjoys a one-year term.[171] A director may serve as an executive officer in a Committee Structure Company, despite the goal of distinguishing between monitoring and execution. This is similar to the general practice in the United States, which allows CEOs or other high-ranking officers to serve as directors.

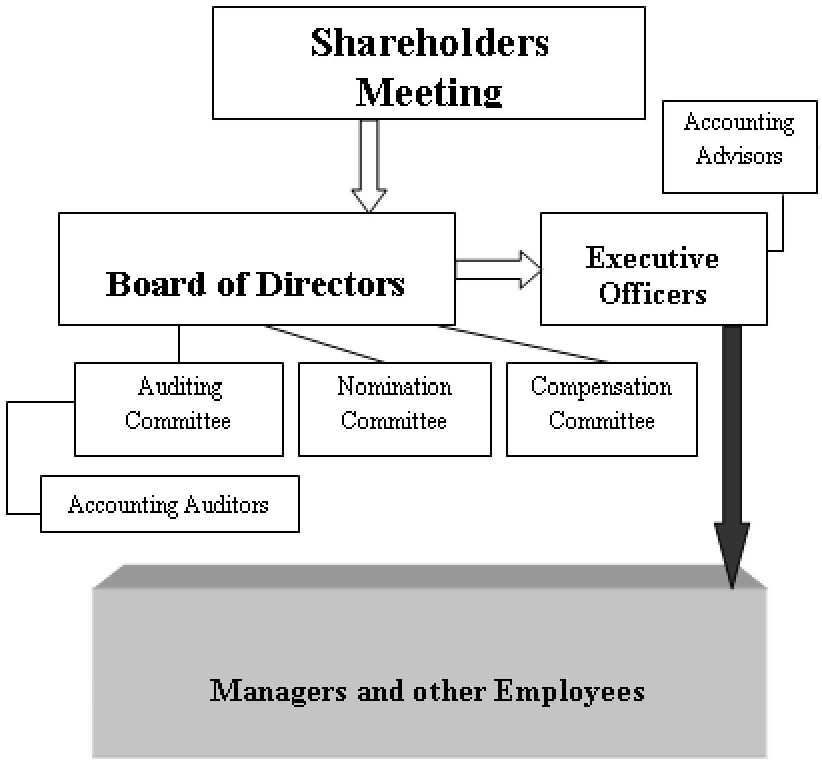

Chart 3: Structure of the Committee Structure Company

Id. art. 332, para. 3. The fact that directors are re-elected annually in shareholders meetings reflects the assumption that the directors in those companies are under more frequent and direct scrutiny from shareholders.

170. *Id.* art. 402, 418-22.

171. *Id.* art. 402, para. 7.

b. The Concept of "Independence"

The defining attribute of the independent director is that the director must not have served as an employee or executive director, and must have no connections to the company's top executive officers or the company itself, aside from receiving compensation. The Japanese Companies Act Article 2(15) defines an independent director as a director:

(1) who is not an executive director[172] nor an executive officer, nor an employee, including a manager, of such Stock Company or any of its subsidiaries, and

(2) who has neither ever served in the past as an executive director nor executive officer, nor as an employee, including a manager, of such Stock Company or any of its subsidiaries.[173]

The conceptual definition of "independent director" in Japan is similar to its definition in the United States. Underlying this concept is the belief that a director's business decisions will be neutral and best reflect the interests of shareholders when made free of undue influence from executive officers.

Although the Committee Structure Company was introduced with the intention of having more directors on the board, the independent director is a separate mechanism. In fact, the concept of the independent director (and independent corporate auditor) was introduced in Japan earlier than the committee structure. Before the formal implementation of the 2002 Amendment to the Commercial Code, which introduced the committee structure, there were at least 261 companies listed on the Tokyo Stock Exchange that had already voluntarily adopted independent directors.[174]

2. The Goal of the Committee Structure Company: Effectuating the Ideals of Enhanced Monitoring and Reinvigorating Business

The Committee Structure Company was introduced into Japanese corporate law to implement a better monitoring mechanism and afford companies more flexibility to pursue their business strategy. This section describes these two forces for change in more detail.

a. Breaking Management Centrism and Enhancing Monitoring

In the explanatory submission and congressional testimony to the 2002 Amendment of the Commercial Code Bill, the Ministry of Justice (MOJ) detailed the reasons for creating the Committee Structure Company.[175] The main reason for

172. Referring to a representative director or director who is appointed by the board to execute business operations. *See* COMPANIES ACT, *supra* note 15, art. 363 para. 1 and *supra* Part II,D,3.

173. *Id.* art. 2, para. 15.

174. TOKYO STOCK EXCHANGE, SURVEY ON MATTERS CONCERNING CORPORATE GOVERNANCE, Nov.30, 2000.

175. The House of Representatives, Judicial Affairs Committee, Discussion Minutes No.9 of 154th session, Apr. 12, 2002.

this amendment was to establish a clearer separation between the monitoring and execution functions in large companies.[176] Before the amendment, most Japanese companies did not maintain a clear distinction between these two functions. Both directors and corporate auditors were traditionally promoted internally, and lifetime employment had created an esprit de corps which resisted outside opinion. As such, the monitoring function had been little appreciated and was rendered insufficient. To cure this situation, three committees were created where outside directors would hold the majority position. The amendment sought to increase the monitoring of the board of directors by creating three committees with a majority of outside directors in order to clarify the separation between executive authority and the monitoring function.[177]

Based on the views expressed in the legislative discussions, the core function of the board of directors in the Committee Structure Company is to monitor executive officers, while maintaining the power to make fundamental decisions like mergers, acquisitions or substantial asset disposition, and to delegate the power to make general business decisions. By delegating the power to carry out business to executive officers, a more centralized management chain can be established, which helps companies conduct business more quickly and more efficiently.[178] At the same time, when executive officers are responsible for and required to report periodically to the board of directors regarding administration of the business, a more clear distinction between "monitoring" and "execution" is set up.[179]

b. Reinvigorating Business by Reducing Restrictions and Providing More Organizational Choices: The Voluntary Approach

Another reason for the creation of the Committee Structure Company is illustrated in the series of Commercial Code amendments since the 1990s. One important theme commonly shared by the amendments since the 1990s was deregulation. The desire to revitalize companies was a major part of legislative reasoning and became especially strong in the midst of economic depression. Japanese legislators reasoned that a more diverse, flexible legal environment would be indispensable in restoring the vitality of corporations and would also help people conduct business more efficiently. Reducing the restrictions of the Commercial Code and empowering companies to choose their own management structure became a major theme and rationale behind the creation of the Committee Structure Company.

In his explanatory submission to the 2002 Amendment, Justice Minister Moriyama made clear that the new organizational form was aimed at "meet[ing] the diverse needs of running a business" and "making the management process

176. *Id.*
177. *Id.*
178. *Id.*
179. COMPANIES ACT, *supra* note 15, art 417, para. 4.

more reasonable."[180] He also stated that the globalization of business and its management, and the tendency of Japanese companies to list on the American or European stock exchanges made the relaxation of the organizational form necessary to meet the challenges of international competition.[181] The Committee Structure Company recognized the needs of different companies and provided a more flexible, legal environment in which companies could more easily adopt their own business and organizational strategies.

Furthermore, in the legislative discussion of the 2002 Amendment, one of the most mentioned elements was the voluntary implementation of the Committee Structure Company. There was consensus among the MOJ, the two diets of Congress, and academics that a voluntary approach best served one goal of the Committee Structure Company, which was to reinvigorate business by providing more governance options.[182] A voluntary approach also eased doubts among business circles, legislators and academics, and avoided the potentially strong resistance to a universally mandated new structure. Voluntary adoption thus became the common ground, and Congress settled with the MOJ's version despite some protests.[183]

C. The Relationship among Independent Directors, Corporate Auditors and the Committee Structure

The mechanism of the independent director and the independent corporate auditor can also be utilized in the traditional dual board structure company. However, independent directors, due to the differences in the committee structure, do not function in the same way.

1. The Independent Director in a Two-Board Structure

The independent director, in theory, can be implemented in either the dual board structure or single board structure. However, the adoption of the single board plus committee structure provides a larger role for the independent director. Two major issues stand in the way of implementing the independent director in the traditional two-board structure. The first is the division of power between independent directors and corporate auditors to oversee management causes confusion, and the second is the absence of a requirement that independent directors be given enough voting power to make their voices heard in a two-board structure.

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180. *Id.*

181. *Id.*

182. *Id.*

183. *Id.* The Communist Party (especially Congressman Matsushima Midori and Kijima Hideo) argued that the 2002 Amendment did not fix the insufficient monitoring problem because: 1) the voluntary approach was not enough to provide a satisfactory motivation for change, and 2) it did not sufficiently stress the related issues of increasing disclosure and strengthening shareholder derivative suits, which are even more fundamental to a better monitoring mechanism.

2. Similarities and Differences in the Roles of the Independent Director and Corporate Auditor

Functionally, the corporate auditor, independent director, and committee structure all work toward the common goal of providing more effective monitoring over management in the absence of adequate direct monitoring by shareholders. Despite this shared goal, they have different effects and may perform differently in certain situations.

a. The Range of Monitoring

Before the advent of the Committee Structure Company, the scope of the corporate auditors' monitoring authority was a fiercely debated issue within corporate legal academia.[184] Traditionally, scholars have been divided into two camps on this issue. Some considered the corporate auditors' monitoring authority to be limited to the legality of the decision of the board of directors. For example, corporate auditors could intervene in the board of directors' decision-making process only when they thought the decision may violate the law or corporate charter. A decision that seemed merely suboptimal, unwise, or inappropriate would not confer authority upon corporate auditors to interfere.[185] Following this interpretation, the responsibility to ensure sophisticated decisions belonged to the board or individual director alone.

Other scholars believe that the scope of the monitoring function of corporate auditors should not be limited to the issue of legality alone. Instead, they argue that the range of monitoring should be expanded to consider propriety. Since the job of the corporate auditor is to monitor the execution of the business, it would not be very meaningful to limit that monitoring power to a consideration of legality alone.[186]

The Committee Structure Company solves these dilemmas because there is only one board. In the Committee Structure Company, the board of directors is responsible for managing the company while monitoring all business decisions, both in terms of legality and propriety. In this sense, the range of monitoring in the Committee Structure Company faces fewer restrictions and is more comprehensive.[187]

b. Voluntary Adoption v. Mandatory Ratio

Independent directors may work within the framework of the traditional two-board structure. However, the confusing division of labor between directors and corporate auditors and the large number of board members prevents independent directors from functioning as expected. Nonetheless, the traditional two-board

184. *See* KANDA, *supra* note 11, at 217 n.1; LAWS OF STOCK CORPORATIONS, *supra* note 117, at 478 n.3.

185. *Id.*

186. *Id.*

187. LAWS OF STOCK CORPORATIONS, *supra* note 117, at 506-07, 514-16.

system can freely coexist with the independent director mechanism under the current rule of Japanese law, and companies can appoint whatever number of independent directors they wish.

While companies using the traditional two board system can choose to also adopt the independent director mechanism, in the Committee Structure Company it is mandatory to have a certain number of independent directors, and the number of independent directors must be able to constitute a majority on the nomination, auditing and compensation committees.[188]

c. *The Tipping Point*

While in theory, the independent director may be implemented in either a two-board or Committee Structure Company, it is generally considered more effective when supported with the combination of a single board and a Committee Structure Company. A larger number of independent directors on the board is the key to a functioning independent director mechanism. Only when independent members make up a significant portion of the board, if not a majority, will they represent a balancing power to management and provide adequate monitoring power to prevent corporate misconduct.

In this sense, one key test of a successful adoption of the independent director mechanism is whether disinterested persons can control the selection of those who are in charge of daily management. From this viewpoint, to require that independent directors constitute the majority of the nomination committee, which is mandatory in the Committee Structure Company, captures the essential benefit of having independent directors on the board.[189] Therefore, the Committee Structure Company provides a better environment for the independent directors to shield themselves from the dominance of those senior directors, though the traditional two-tier board structure does not prevent independent directors from joining the board and exerting their influence over it.

3. Old Rules Reincarnated in the Audit Committee

Although the audit committee in Japanese corporate law was intended to mimic the American system, it is in fact closer to Japan's previous corporate auditor system than it is to the audit committee structure in the United States. In introducing the committee structure, Japanese legislators strangely crafted the rules about audit committees based on their understanding of the traditional corporate auditor. As a result, the members of the audit committee or the audit committee itself play a very similar role to the corporate auditors or the board of corporate auditors.

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188. COMPANIES ACT, *supra* note 15, art 400, para.3.

189. Some might argue that if the independent directors are poorly picked by the nomination committee and lack real independence, the difference between the traditional insider board and the committee structure is eliminated. Despite the risk of such misuse, which would substantially undermine the new design's expected function, the structural difference still makes the interference from the CEO more difficult.

For example, the members of the audit committee are endowed with the same power as the corporate auditors to represent the company and bring suit when the company needs to sue its directors or executive officers.[190] Similarly, when the director unintentionally and without serious fault causes damage to the company, shareholders have the power to partially waive the directors' liability and allow a damage cap if all members of the audit committee or all of the corporate auditors have agreed to waive the default rule in law.[191] By way of another example, both members of the audit committee and the corporate auditors have the same right to convene a shareholders meeting when needed, and can bring a bill to the shareholders meeting for discussion. In light of this, the audit committee in Japan has moved the traditional corporate auditor system into the board of directors more than it has copied the American-style audit committee.[192]

The similarity between the functions and rules of the audit committee and corporate auditors in Japan makes the committee structure a deviation from the U.S. model that it intended to mimic. On the one hand, this phenomenon indicates the difficulty involved in transitioning from one institutional design to another, and the risk that mistakes can be made in this process. On the other hand, the strategy to use old rules in this transition spoils the comparative advantage a competing mechanism is thought to offer and may destroy the intended result of a legal transplant.[193]

D. Implementation of the New Organizational Mechanisms and Domestic Reactions

1. The Committee Structure

After the passage of the 2002 Commercial Code Amendment, which allows the creation of American-style board committees, several companies in Japan announced plans to reorganize their boards.[194] In the beginning, the companies that planned to move toward the committee structure were mostly those who received more foreign capital or had the need to comply with foreign listing regulations due to cross-listing (especially those also listing in the United States). One important

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190. COMPANIES ACT, *supra* note 15, art 405-08*; see also* KANDA, *supra* note 11, at 218.

191. *Id.* art. 425, para. 3.

192. One possible explanation for duplicating rules about the corporate auditor is the desire to retain the old buffer between shareholders and directors or executive officers in order to avoid direct conflict such as shareholder suits. This is particularly true as the 2002 Amendment and the new Companies Act did not significantly change the rules about the current shareholder suit mechanism.

193. Another implied reason for the voluntary adoption of the Committee Structure Company was the hope that it would help trigger a "competition among different designs," and in turn would lead to a productive competition with the traditional corporate auditor mechanism and eventually an overall enhancement of monitoring. *See* LAWS OF STOCK COMPANIES, *supra* note 117, at 284.

194. Allison Dabbs Garrett, *Themes and Variations: The Convergence of Corporate Governance Practices in Major World Markets*, 32 DENV. J. INT'L L. & POL'Y 147, 168 (2004).

example is Sony Corporation.[195] However, the trend quickly slowed, and the number of companies now transitioning to the Committee Structure is surprisingly few.

a. Data: Surveys in 2005 and 2009

In a 2005 study conducted by the Japanese Association of Corporate Directors, based on filing material and other public information, there were sixty-seven publicly traded companies who adopted the committee structure by September 1, 2005. However, among the sixty-seven companies, forty-four of them adopted this transformation in 2003, thirteen companies adopted in 2004, and ten adopted in 2005, which represents a clear tendency of gradual reduction in the number of companies shifting from a traditional two-board structure to a new one-board structure.[196]

Forty-nine of the sixty-seven Committee Structure Companies are listed on the Tokyo Stock Exchange First Section (for large companies), which contained 1667 companies at the end of 2005, and seven are listed on the Tokyo Stock Exchange Second Section (for mid-sized companies), which contained 506 companies at the end of 2005.[197] Others are listed on markets such as the Tokyo Stock Exchange MOTHERS Section (Market of the High-Growth and Emerging Stocks), JASDAQ (Japan Over-the-Counter Market) and the Osaka Stock Exchange. This distribution provides no clear evidence that company size mattered in the decision about whether to shift to the committee structure.

Also worth noting is the fact that the Hitachi group comprises nineteen positions (roughly twenty-eight percent) of the sixty-seven companies. If

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195. Upon transitioning to the committee structure, as of July 2006, Sony Corporation had fourteen directors among which three are representative corporate executive officers who head the corporation and are responsible for carrying out daily business decisions. These three representative corporate executive officers (Howard Stringer, Ryoji Chubachi and Katsumi Ihara) are Chairman/CEO, President/Electronics CEO, and Executive Deputy President/Officer in charge of Consumer Products Group respectively. Seven leading officers constitute the executive group. The executive group is led by and includes the three representative corporate executive officers who are the only three persons out of the seven executive group officers who concurrently hold directorship. *See* Sony Global, Corporate Governance, http://www.sony.net/SonyInfo/IR/info/strategy/governance.html (last visited Mar. 25, 2010); Sony Global, Executives, http://www.sony.net/SonyInfo/CorporateInfo/executive/index.html (last visited Mar. 25, 2010). For a discussion and comparison of Sony's governance standard and the New York Stock Exchange's corporate governance standards, *see* Sony Global, Significant Differences Between the New York Stock Exchange's Corporate Governance Standards and Sony's Corporate Governance Practices, http://www.sony.net/SonyInfo/IR/info/strategy/NYSEGovernance.html (last visited Mar. 25, 2010).

196. Japanese Association of Corporate Directors, *List of Companies Shifting to Committee Structure*, http://www.jacd.jp/report/050901_01report.pdf (last visited Mar. 25, 2010).

197. For statistics about the number of all listed companies in the Tokyo Stock Exchange in the past, *see* Tokyo Stock Exchange, Change of the Numbers of Listed Companies, http://www.tse.or.jp/listing/companies/past.pdf (last visited Mar. 25, 2010).

excluding Hitachi group, the real number of companies that have shifted to the committee structure is much smaller than it appears.

In another survey conducted by the Japanese Corporate Auditor Association in April 2009, 112 companies, including thirty-nine non-publicly traded companies, had adopted the committee structure. Considering the total number of companies in Japan, the number is lower than what one might expect.

	Publicly Traded Company	Non-Publicly Traded Company	Total
2003	38	17	55
2004	13	8	21
2005	9	4	13
2006	4	3	7
2007	4	5	9
2008	4	1	5
2009 (as of April 10, 2009)	1	1	1
Total	73	39	112

Table 1: Number of Companies Adopt Committee Structure by Year[198]

b. Observations

This raw data requires further attention. The first observation worth noting is the low adoption rate of the committee structure. By March 31, 2009, the Tokyo Stock Exchange First Section contained 1,718 companies. However, only fifty-four of them have adopted the committee structure, which is only slightly above three percent. The ratio on the Tokyo Stock Exchange Second Section is less than one percent (four out of 457). In total, almost seven years after the 2002 amendment, only 2.3 percent of all TSE-listed companies have adopted committee structure. The remaining 97.7 percent of the companies still use corporate auditors.[199]

Furthermore, two corporate groups account for a large percentage of the committee structure adoption: Hitachi Electronics and Nomura Securities. These

198. Japan Corporate Auditors Association, Committer Structure Company List, http://www.kansa.or.jp/PDF/iinkai_list.pdf (last visited Mar. 25, 2010). The above figures exclude the twenty companies that returned to a traditional structure between 2003 and 2009. Among seventy-three public traded companies adopting committee structure by April 10, 2009, fifty-four are listed on the Tokyo Stock Exchange First Section, four are listed on the Tokyo Stock Exchange Second Section, and fifteen are listed on other markets or stock exchanges.

199. TOKYO STOCK EXCHANGE, WHITE PAPER OF CORPORATE GOVERNANCE 2009 15 (2009), *available at* http://www.tse.or.jp/rules/cg/white-paper/white-paper09.pdf [hereinafter TOKYO STOCK EXCHANGE, WHITE PAPER 2009]. In addition, the committee structure adoption rate dropped to 2.3%, down from 2.5% in the last survey conducted in 2006.

two groups take up about twenty-eight percent of all companies adopting the committee structure in Japan.[200]

	All	Hitachi Group	Nomura Group	Other (excluding Hitachi and Nomura)
Publicly Traded	73	16	1	56
Non Public	39	1	13	25
Total	112	17	14	81

Table 2: Number of Companies Adopt Committee Structure by Year in Contrast to Two Major Corporate Groups Who Actively Adopt Committee Structure

2. Independent Directors

The surveys mentioned above are limited to the companies adopting the committee structure after the 2002 amendment of the Commercial Code. As mentioned, companies in Japan can still have independent directors on their board without opting for the committee structure. The following numbers clearly indicate that Japanese companies do not consider the implementation of the independent director mechanism to necessarily be linked to adopting the committee structure.

a. The Number of Companies Having Independent Directors

	1998	2000	2002	2006	2008
Companies Surveyed	1137	1310	1363	2356	2378
Companies Having Independent Directors (Percentage)	35.5	19.9	28.5	42.3	45.4

Table 3: The Percentage of Companies Having Independent Director (All TSE-Listed Companies) [201]

200. Japanese Corporate Auditors Association, 2009/4/10.

201. Data in 1998, 2000 and 2002 are all based on surveys conducted by the Tokyo Stock Exchange of all companies listed on the Tokyo Stock Exchange. Survey participation was voluntary, and only 62.4, 65.7 and 64.8 percent of listed companies participated in surveys of 1998, 2000, and 2002 respectively. In 2006 and 2008, the survey covered all listed companies and participation is mandatory. The same is for the data in Table 4 and 5. TOKYO STOCK EXCHANGE, WHITE PAPER OF CORPORATE GOVERNANCE 2007 14 (2007), *available at* http://www.tse.or.jp/rules/cg/white-paper/white-paper07.pdf [hereinafter TOKYO STOCK EXCHANGE, WHITE PAPER 2007]. TOKYO STOCK EXCHANGE, SURVEY RESULT ON CORPORATE

Looking broadly at the data, by the end of 2008, about forty-five percent of companies listed on the Tokyo Stock Exchange had independent directors on the board. In fact, the number grew from about twenty percent in 2000 to thirty percent in 2002, which clearly represents a trend of steady growth.

b. The Average Number of Directors and Independent Directors

	1998	2000	2002	2006	2008
Percentage of Companies Having 20 to 29 Directors on Board	14.4	9.7	5.1		
Percentage of Companies Having 10 to 19 Directors on Board	47.8	45.3	37.7		
Percentage of Companies Having 5 to 9 Directors on Board	20	31	50.2		
Average Number of Directors				8.99	8.68

Table 4: Average Number of Directors (all TSE-listed companies)[202]

	1998	2000	2002	2006	2008
Percentage of Companies Having One Independent Director, in All Companies Which Have at Least One Independent Director	43.6	48.3	52.3		
Percentage of Companies Having Two Independent Director, in All Companies Which Have at Least One Independent Director	26.7	28	25.8		
Average Number of Independent Directors in All Companies				0.81	0.86
Average Number of Independent Directors in All Companies Which Have at Least One Independent Director				1.91	1.90

Table 5: Average Number of Independent Directors (all TSE-listed companies)[203]

GOVERNANCE MATTERS 3 (2003), *available at* http://www.tse.or.jp/rules/cg/enquete/vol_3.pdf [hereinafter TOKYO STOCK EXCHANGE, SURVEY 2003]. TOKYO STOCK EXCHANGE, SURVEY RESULT ON CORPORATE GOVERNANCE MATTERS 3 (2000), *available at* http://www.tse.or.jp/rules/cg/enquete/vol_2.pdf [hereinafter TOKYO STOCK EXCHANGE, SURVEY 2000]. TOKYO STOCK EXCHANGE, SURVEY RESULT ON CORPORATE GOVERNANCE MATTERS 3 (1998), *available at* http://www.tse.or.jp/rules/cg/enquete/vol_1.pdf [hereinafter TOKYO STOCK EXCHANGE, SURVEY 1998].

202. TOKYO STOCK EXCHANGE, WHITE PAPER 2009, *supra* note 199, at 18; TOKYO STOCK EXCHANGE, WHITE PAPER 2007, *supra* note 201, at 14-15; TOKYO STOCK EXCHANGE, SURVEY 2003, *supra* note 201, at 3.

203. TOKYO STOCK EXCHANGE, WHITE PAPER 2009, *supra* note 199, at 18; TOKYO STOCK EXCHANGE, WHITE PAPER 2007, *supra* note 201, at 14-15; TOKYO STOCK EXCHANGE, SURVEY

As demonstrated in Table 4, the size of boards of directors has been substantially decreasing in the past decade. Although the average number of independent directors for those companies having independent directors on their board is staying roughly the same (slightly below 2). The dwindling size of boards of directors gives independent directors more say on the corporate boards.

c. Number Distribution

Company Type	Non Committee Structure		Committee Structure	
Person(s)/ Year	2006	2008	2006	2008
0	59.2%	55.9%	0%	0%
1	22.2%	23.4%	0%	0%
2	11.1%	12.6%	6.8%	3.6%
3	4.5%	5.1%	35.6%	38.2%
4	1.6%	1.7%	25.4%	20.0%
5	0.7%	0.8%	11.9%	20.0%
6	0.4%	0.3%	3.4%	5.5%
7	0.2%	0%	10.2%	5.5%
8 and up	0%	0%	6.8%	7.3%
Average	0.72 person(s)	0.78 person(s)	4.37 person(s)	4.47 person(s)

Table 6: Number of Independent Directors and Its Distribution on Companies Listed on Tokyo Stock Exchange[204]

d. Background and Relationship

Company Type	Non Committee Structure		Committee Structure	
Attributes/Years	2006	2008	2006	2008
Person Who Retired From Unaffiliated Companies	84.3%	92.4%	73.6%	72.4%
Attorney at Law	4.3%	6.6%	9.3%	9.3%
Certified Public Accountant	1.3%	1.7%	6.6%	5.7%
Certified Tax Accountant	0.7%	0.6%	0.8%	1.2%
Academic	4.2%	5.5%	6.2%	7.7%
Other	5.3%	8.1%	3.9%	3.7%

2003, *supra* note 201, at 3; TOKYO STOCK EXCHANGE, SURVEY 2000, *supra* note 201, at 3; TOKYO STOCK EXCHANGE, SURVEY 1998, *supra* note 201, at 14-15.

204. TOKYO STOCK EXCHANGE, WHITE PAPER 2009, *supra* note 199, at 18-19.

Table 7: Background of Independent Directors in the TSE-Listed Companies[205]

Companies Type	Non Committee Structure		Committee Structure	
Attributes/Years	2006	2008	2006	2008
From Parent Company	12.7%	10.2%	18.2%	19.1%
From Affiliate Companies	14.1%	12.7%	7.8%	5.7%
Is a Major Shareholder	20.6%	16.1%	14.3%	8.9%
Also an Independent Director of Other Company	42.2%	45.7%	57.4%	60.6%
Also an Executive Officers/Directors of Other Company	45.3%	46.0%	37.2%	31.7%
Relative of Executive Officers/Directors	2.3%	2.8%	1.6%	5.3%
Receiving Compensation as an Officer from the Parent of the Company or a Subsidiary of the Parent	8.2%	5.7%	18.2%	19.1%

Table 8: Relationship between the Independent Director and His/her Company in the TSE-Listed Companies[206]

e. Observations: Explaining the Disparity

The above data provides insight into the implementation of the independent director mechanism in Japan. From the outset, the independent director mechanism established a slow but strong presence with a steady growing pace in corporate Japan, and this trend started even before the late 1990s.[207] The adoption rate of the Committee Structure Company was still lower than one might have expected; however, the disparity may not be as accurate as it first appears.

205. *Id.* at 22-23.

206. *Id.* at 24-25.

207. For the data before 1998, Yoshiro Miwa and J. Mark Ramseyer provide a survey of the independent director in the top 1000 public companies in Japan in 1985, 1990 and 1995. The average independent director to all directors ratio in 1985, 1990, and 1995 were respectively 4.70/19.49, 4.90/21.16 and 5.14/21.26. One thing that needs particular attention is that the numbers in their survey included both directors and corporate auditors. In this regard both parts of the ratio are larger compared to the latter surveys. Yoshiro Miwa & J. Mark Ramseyer, *Who Appoints Them, What Do they Do? Evidence on Outside Directors from Japan*, 14 J. ECON. & MGMT. STRATEGY 299, 309 (2005).

As mentioned earlier, under the current custom in Japan, simply having one or two independent directors on the board generally does not have a substantial effect because the CEO still has considerable influence over the other members of the board. Therefore, opting for a committee structure may be the only way to provide for a functioning independent director mechanism in a company. This stands in theory as well because the committee structure provides more institutionalized assistance for the independent directors to execute their roles as a monitoring mechanism, and grants them more power in matters such as director nomination, compensation and audit.

Given that the 2002 amendment requires only two independent directors to form a Committee Structure Company, the low rate of adoption of the committee structure seems peculiar, but there may be reasons why companies that already have two or more independent directors do not opt for the Committee Structure Company. First, the committee structure requires the board to relinquish certain powers to committees, some of which are composed mostly of independent directors. This means other members of the board (including the CEO) may need to give up some of their corporate powers, which invites resistance. Second, choosing the committee structure means abolishing corporate auditors. In reality, most corporate auditors cannot transform into independent directors easily. Many current auditors cannot qualify as independent directors because they do not meet the criterion of independence if they have ever been employees in the company.

In summary, shifting from the two-board system to the committee structure would lead to a reallocation of corporate power among board members and corporate auditors, which the board and CEO may want to avoid. This may explain why few companies have chosen to shift to a committee structure in Japan.

E. The Political Bargaining Behind the 2002 Reform of Commercial Code

The importation of a U.S.-style board structure did not engender fierce debate or much disagreement in Japan. Though some minor disagreements remained among different groups, the direction was generally accepted in most government and business circles. Academia, however, has mixed opinions regarding the incorporation of the independent director mechanism.

1. The Government's Position

By the mid-1990s, opinion leaders started to call for a curtailment of corporate mismanagement and for corporations to be more accountable to shareholders. The Commercial Code Subcommittee (*shouhou bukai*) of the MOJ's Legislative Council (*housei shingikai*), an advisory body dominated by prominent scholars, also started to work on an overhaul of Japanese corporate law beginning in the mid-1990s. The Commercial Code has been amended frequently since the early1990s, and as mentioned earlier, the two primary lines of reforms aimed to provide a less restrictive legal environment for encouraging corporations to combat the economic downturn, and to enhance monitoring to stop corporate mismanagement.[208]

The Ministry of Economy, Trade and Industry (METI) and the MOJ both support the reform of corporate law in principle. MOJ officials saw the reform of the Commercial Code as part of a larger effort, which included industrial revitalization and the accountability reforms, to facilitate corporate adjustment by modernizing Japan's market infrastructure. The MOJ officials worked as mediators between the business community and the scholars on the Commercial Code Subcommittee, who wanted to allow companies to move toward a United States-style governance system while preserving Japan's more "rational" (meaning less costly) legal framework.[209] MOJ officials' position was that Japan did not have powerful shareholder activists or enough class action suits to force changes in corporate governance—and did not need them—but it did need to enhance the existing system, and one way to do so was by strengthening the mechanism of corporate auditors.[210]

In the process of deliberating the 2002 Amendment, Keidanren successfully lobbied against a proposal that would have required all companies to appoint at least one outside director. However, as the current definition of outside director includes employees of a parent company, a subsidiary of the parent company, or a major shareholder, the Japanese government in fact allows companies to use independent directors to strengthen the traditional corporate group structure.[211] Also, due to the lack of effective judicial review, and the expansive definition of the outside director, the new committee structure boards could actually reinforce "stakeholder tunneling" and managerial governance.[212]

2. The Business Associations and Company Level

From the business side, some industry associations and political parties represent both the advocates and opponents of reform, so they do not push for the all-out victory of one side, but rather endeavor to arrange careful compromises between the two, as with the final result of voluntary adoption of the committee structure in the 2002 Amendment. In reality, the divergence of interests between advocates and opponents of reform is not as large as imagined, but is mostly about degree and the method of implementing the new board design.

For example, the Japan Chamber of Commerce and Industry (*Nikkeiren*), which represents small businesses, insisted that Japan should not emulate the U.S.

208. Milhaupt *supra* note 3, at 98.

209. JAPAN REMODELED, *supra* note 50, at 92.

210. *Id.*

211. *Id.* at 94.

212. Ronald J. Gilson & Curtis J. Milhaupt, *Choice as Regulatory Reform: The Case of Japanese Corporate Governance*, 53 AM. J. COMP. L. 343, 370-71 (2005) (Arguing that without the complement of exacting ex post judicial review, the new committee system - in tandem with the Code's expansive definition of outside director - could actually become a potent new governance technology for stakeholder tunneling and managerial entrenchment).

model.[213] *Nikkeiren* favored modest adjustments but stressed that Japan should retain the positive aspects of Japanese corporate governance, including putting a premium value on human resources and taking a long-term view.[214] The Japan Business Federation (*Nippon Keidanren*), Japan's most powerful industry federation and its largest business lobby[215]—representing competitive rather than protected sectors—advocated liberal reform, though, more moderate than expected, and supported bringing in a U.S.-style board structure to increase companies' options.[216]

Meanwhile, large corporations began to show an interest in various reforms of corporate law, hoping that they would help them cope with the economic downturn. The reforms included measures such as supporting share price, selling assets, reorganizing operations, or otherwise reducing cost.[217] At the same time, they also feared those reforms would make it harder for them to pursue long-term strategies and would undermine old preferential relationships with banks. They were especially wary of losing managerial discretion via measures to mandate outside directors or strengthen shareholder accountability. Those corporations with close labor-management ties, such as steel producers and other large-scale manufactures, were more reluctant to tamper with the system than service companies, which were more favorable to reform.[218] Beyond these positions, corporations' stances on reform varied considerably depending on the philosophy of top managers.

3. Academia

Academia has a mixed opinion on Japan's independent director mechanism. In general, many scholars agree that the introduction of the committee structure

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213. JAPAN REMODELED, *supra* note 50, at 57.

214. *Id.* at 56.

215. Nippon Keidanren is the result of the 2002 merger of Keidanren (The Federation of Economic Organizations, the then main Japanese business organization) and Nikkeiren (The Japan Federation of Employers' Association). Formerly, Keidanren focused more on policy issues such as free trade, deregulation, fiscal and environmental regulations, and Nikkeiren focused more on labor issues and employment relationships. Nippon Keidanren (sometimes abbreviated as Keidanren) currently has more than 1500 members, which includes 177 national industrial associations and local economic groups. *See* Nippon Keidanren, About the Japan Business Federation, http://www.keidanren.or.jp/japanese/profile/pro001.html (last visited Mar. 27, 2010).

216. JAPAN REMODELED, *supra* note 50, at 57, 137.

217. The main theme of various reforms adopted by Japanese companies in the 1990s is downsizing and cost-reduction. In addition, many companies took the advantage of de-regulation and created spin-offs, conducted shared buybacks, or issued stock options. Corporate board reform, for most companies, was either not on the top of their agenda or insubstantial even when adopted. *See* JAPAN REMODELED, *supra* note 50, at 134-38.

218. Steven Vogel provides an in-depth discussion of eight case studies on how corporate restructuring proceeds on the individual company level and their different approaches. *Id.* at 164-96.

and independent director will help enhance monitoring and bring benefits.[219] However, uncertainty and a tint of skepticism are observed in scholars' comments as they welcome this change. Their concerns and critiques fall into two categories.

One concern about the independent director in Japan is its effectiveness. As many academics indicated, the independent director cannot guarantee more effective monitoring for several reasons. First, some commentators challenge the expertise of the independent directors and their knowledge of specific industries or firms.[220] They express doubts about whether independent directors, who spend only one or two days a month deciding corporate affairs, have enough exposure to understand the company and make wise decisions.[221] Second, whether there are enough qualified individuals willing to serve as independent directors is a concern.[222] In contrast, corporate auditors in Japan, who mostly are promoted from the hierarchy of the company command chain, have certain advantages stemming from their knowledge of the firm, and the fact that they generally spend more time in the company. The competitive advantages possessed by corporate auditors correspond to what independent directors lack for, and those features make corporate auditors more capable of discovering potential misconduct.[223]

Further, in terms of interest alignment, corporate auditors, most of whom are insiders or former insiders, tend to have more financial entanglement with the company and this entanglement in turn may make them more committed to quality monitoring. On the contrary, the financial entanglement with the company is less obvious or less important in the case of independent directors, making the independent directors' quality monitoring less motivated.[224] There is also uncertainty among commentators about whether the independent director can actually be independent in the Japanese corporate environment and perform his or her monitoring role.[225]

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219. Naoto Nakamura, a Japanese lawyer who is active in shareholder and corporate law litigation, summarizes several reasons for introducing the independent director to companies in Japan based on his personal contacts with business circles. These reasons include: (a) having opinions from a wider perspective; (b) bringing in new viewpoints and avoiding dominance by the leading manager; (c) creating tension within the board of directors to produce a real discussion and avoid dominance by one single opinion; and (d) to improve the quality of business decisions and increase the monitoring. *See* NAOTO NAKAMURA, SHAGAI TORISHIMAYAKU [OUTSIDE DIRECTOR] 2-12 (2004).

220. *See*, *e.g.*, HIDEYUKI KOBAYASHI ET AL., SHINKAISHAHOU TO KOPORETO GABANASU [NEW COMPANY ACTS AND CORPORATE GOVERNANCE] 35 (2005).

221. *See*, *e.g.*, NAKAMURA, *supra* note 219, at 17.

222. KOBAYASHI ET AL., *supra* note 220, at 36.

223. *See*, *e.g.*, Takeshi Yoshii, *Nihon No Kansayaku Seido*, No.1694 JUNKAN SHOJI HOUMU [COMM. L. REV.], 9 (2004); Shinichi Suzuki, *Kansa Iinkai To Kansa Yaku Kai Nikansuru Sentaku Sei [On the Choice Between Audit Committee and Board of Corporate Auditors]*, No. 1732 JUNKAN SHOJI HOUMU [COMM. L. REV.], 28 (2005).

224. NAKAMURA, *supra* note 219, at 17.

225. KOBAYASHI ET AL, *supra* note 220, at 45. Similar concerns were raised about whether or how to adequately perform the monitoring role also arises for the corporate auditor. *See* NAKAMURA, *supra* note 219, at 38, 46.

The second group of concerns relates to the issue of how to reconcile the independent director mechanism with the original corporate auditors system. For most Japanese companies, the most difficult part of implementing the independent director mechanism is to reconcile it with traditional corporate auditors, or put differently, to remove the corporate auditor and then implement the independent director. The longevity of the corporate auditor system makes its replacement with another mechanism a difficult task, in either an individual company or industry-wide.[226] Despite its longevity and pervasiveness, the corporate auditor as a corporate design has not received high marks from academics because it has not met expectations.[227]

The 2002 Amendment, which adopted the two-track system, seemed to signal a victory for reformists. However, the situation has changed since 2003, when the economy in Japan started to recover. Momentum again has started to shift back towards the corporate auditor within the traditional governance model, and hence indicates a more conservative attitude toward new governance structure.

IV. ANALYSIS

The result of implementing the independent director mechanism along with the committee structure in Japan invites alternative analysis of the design itself and its viability. The implementation also provides a good opportunity to review several important issues in both corporate law theory and the study of comparative corporate law. While the future of the independent director mechanism and the committee structure is still an open question in Japan, several factors, and the perception people have toward these factors, may well shape the future of this new corporate design.

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226. For example, corporate auditors in Japan formed a cross-industry Corporate Auditor Association, which has been lobbying actively and has considerable influence. In addition, as an organization having about 6,000 members, it works extensively on promoting better governance and continuous education for corporate auditors. For more information about Japanese Corporate Auditor Association, see Japan Corporate Auditors Association, http://www.kansa.or.jp/english/index.html (last visited Mar. 27, 2010).

227. According to general perception in Japan, people tend to reserve their confidence in the corporate auditor and have felt less satisfactorily toward its role in modern business corporations. This is indeed the reason for an on-going process of reform of the Japanese corporate auditors system. For a general discussion, see*, e.g.*, Kazuhiro Take, *Kansa Yaku Secchi Kaisha Niokeru Arata Na Kigyou Touchi No Houkou Sei— Kaitei Kansa Yaku Kansa Kijun No Kaisetsu* [*The New Direction of Corporate Governance for Companies with Corporate Auditors---Explanation of the Amendment of "The Standard of Monitor for Corporate Auditor"*], No. 1705 JUNKAN SHOJI HOUMU [COMM. L. REV.] 61, 62 (2004). For the discussion of the lobbying of Corporate Auditor Association of Japan and its push for reform (and the fight for survival), see *id.* at 61-73.

A. The Core Issue Re-identified

One key corporate governance problem in Japan is the conflict between a company's managers and its shareholders.[228] While other agency problems may take place from time to time in Japan,[229] and the independent director mechanism can serve other functions, such as providing objective advice, issues arising from manager/shareholder agency are the most prevalent.

The insufficient ability to control and monitor senior managers has been a focus of reform since the 1970s, illustrated by the amendments concerning corporate auditors from the 1970s to the Companies Act of 2005.[230] The same concern of inadequate monitoring within companies was the main reason behind designing a new governance structure and introducing the independent director mechanism in Japan in 2002, as was indicated in the repeated language of "enhancing monitoring within companies" both in the draft by the MOJ and congressional deliberation.[231]

B. The Comparative Merit of Independent Directors

There are three advantages that independent directors have in comparison to corporate auditors: a higher degree of independence, better control over the CEO selection, and structural simplicity. Though different in degree, adoption of the independent director mechanism and committee structure is justified by all three advantages if the shareholder/manager agency problem is the key problem to be dealt with in the Japan corporate world, and provided that they outweigh the corporate auditor's intrinsic advantage of greater firm specific knowledge and the overall cost of reform,.

1. Back to a Normative Approach

In discussing the merits of the independent director mechanism, two questions, closely related, must be addressed in advance. Whether the independent director mechanism has merit, and to what degree or under what circumstances, is a question that should not be confused with whether the corporate auditor or independent director is the *superior* monitoring mechanism for Japan. The first question focuses on the examination (both in theory and its implementation) of the

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228. In fact, insufficient ability to control and monitor, either from the board of directors or board of corporate auditors, has been a central issue in Japan for decades. This is major reason why an alternative governance structure was proposed (i.e., committee-type company). In other words, it is hoped to break the CEO's dominance and provide a real monitoring mechanism to corporate Japan by introducing committee-type company. *See* Shigery Morimoto, *Tou Secchi Kaisha Seido No Rinen To Kinou Jou: Kansa Iinkai To Kansa Yaku Seido No Hikaku O Chuushin Ni* [*The Idea and Function of Committee Type Company System I: Focusing on the Comparison of Audit Committees and Corporate Auditors*], 1666 JUNKAN SHOJI HOUMU [COM. L. REV.] 4 (2003);YUKIMI KAWAGUCHI, SHAGAI TORISHIMAYAKU TO KOPORETO GABANASU [OUTSIDE DIRECTORS AND CORPORATE GOVERNANCE] 175 (2004).

229. For example, the controlling shareholder/non-controlling shareholder agency problem.

230. *See supra* Parts I.A, I.B.

231. *See supra* notes 175-81 and accompanying text.

independent director mechanism itself, and explores whether it can solve the problem for which it is designed. The second question focuses on whether there is a comparative advantage between the independent director mechanism and other mechanisms. Although these two questions are similar, it is still possible to conclude, in theory, that while the independent director is a better monitoring mechanism, it remains unclear whether it possesses any merit to enhance company performance.[232]

2. Higher Degree of Independence

The first advantage of an independent director mechanism is that is offers independence. Although it is difficult to materialize "real independence" through legal demand, it is less doubtful that an independent director can from the outside, without heavy financial reliance on director compensation, perform a more sufficient monitoring job compared to an internally-promoted professional manager whose job and financial security largely rely on maintaining his job in that company. Having said that, in fact, it is easy to find many "not-independent" directors who would nonetheless meet the legal requirements of being "independent." Further, the same independence can be achieved by employing "real-independent" corporate auditors from the outside. Independence is not something that can be achieved merely by conceiving a different organizational design. Other factors, such as liability rules or cultural reasons, affect independence.[233] However, in the comparison between corporate auditor and independent director, because specified power is reserved to committees that are composed predominantly of independent directors, independent directors in committee structure companies have more direct control over certain corporate decisions than corporate auditors in the corporate auditor system. Hence, there is a greater possibility of independent directors achieving actual behavioral independence.

3. Better Control over CEO Selection

The second advantage of the independent director system is entangled with the third, and both pertain to independent directors working within companies that

232. This implies that the corporate auditor in Japan may be "negative" to corporate performance as a whole. However, this is not the conclusion this article reaches. For a more detailed discussion about the value of the corporate auditor and the possible way to reform it, see *infra* Part IV.

233. One similar argument for the independent director is that it can provide better transparency, allowing shareholders and investors to have a better position to understand what is going on inside the company. *See, e.g.*, Hideki Kanda, *Kaishahou No Kendaika To Koporeto Gabanasu (The Modernization of Company Law And Corporate Governance)*, *in* KOPORETO GABANASU NIOKERU SHOHO NO YAKUWARI (CORPORATE GOVERNANCE AND THE ROLE OF COMMERCIAL LAW) 37 (Hideki Kanda ed., 2005). In fact, this is the same argument for using the independent directors to break up insider dominance and to provide more relevant information to the general public and investors, and it in turn links to the function of outside monitoring and the ability to act independently.

have also adopted the committee structure. In Japan, the board of corporate auditors is parallel to the board of directors. Its function is supplementary and limited to a particular range. The board of corporate auditors does not have the authority to elect directors, nor the power to relieve directors of duty.[234]

In a single board structure, especially when independent directors have a majority of the seats on the board, they can exert the power to elect and remove top managers and delegate managing power; the most powerful monitoring weapon.[235] Even in a less favorable scenario when independent directors do not constitute a majority on the board, they can still strongly influence the selection of a new CEO or representative director by naming him or her as a director. This decision can substantially reshape the power structure in a company. Thus, under a single board structure, the hierarchy and the restoration of the right to participate in the appointment of the CEO and other high ranking officers will help to reestablish the authority of the board of directors over managers.

4. Structural Simplicity

The third advantage of independent directors is structural simplicity. Though parallel in appearance, the two-board system does not contain two, equally equipped boards, but rather one large, powerful board of directors and one small, weak board of corporate auditors.

A structure that divides authority between the two boards weakens each board's authority to manage, and confuses the power and the duty to monitor. For employees and managers, it is difficult to face two boards with dual loyalty when disagreements arise. Likewise, when management must report to two boards, the authority of each board is weakened and management tends to feel like it is not under direct control.

Furthermore, a two-board system requires more communication and will be less efficient. It makes sense to consolidate the monitoring bodies. This unification would also help solve the continuous disagreement on the range of oversight in Japanese corporate law literature, and lead to more effective monitoring.

Moreover, when it is established that the board has the complete authority to run a company, it will help the employees who are lower on the chain of command

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234. The power to relieve the duty of a director is reserved to the shareholders meeting in Japan. With the majority resolution, the shareholders meeting can demand the director resign even without just cause. *See* COMPANIES ACT, *supra* note 15, art. 339, para. 1. If no majority resolution is reached, minority shareholders who own three percent outstanding shares can request the court to relieve a director from his post in cases of just cause, such as when certain illegal acts are committed by a director.

235. Misao Tatsuta pointed out that the crucial question about the independent director mechanism in Japan is not whether they are independent enough or how the law defines it, but whether they are able to form a majority. Misao Tatsuta, *Nihon no Koporeto Gabanasu No Kihon Mondai (The Basic Problem of Japanese Corporate Governance)*, No. 1692 JUNKAN SHOJI HOUMU (COMM. L. REV.) 7-8 (2004).

to establish a concrete sense of agency (i.e., primacy of shareholders). Unification will also build a stronger sense of responsibility since everyone can more easily understand that it is the board of directors, not the CEO or representative director, who is the legal source of the power. Once this recognition exists, more effective and accurate monitoring will occur and, in turn, create a clearer sense of shareholder primacy.

On the procedural side, the simplification of corporate organs—merging two boards into a single board for monitoring purpose only (monitoring model)—would help to reduce redundancy and cost. This procedural benefit is especially true when both boards are tasked to the same function: providing a controlling mechanism to managers. The division does not provide a credible justification for its own existence, either in theory or in practice. In this sense, simplicity in structure will bring many benefits, such as cost-efficiency and clarity to current corporate designs.

In short, a single board structure with an adequate number of independent directors can more effectively monitor management by bringing all related people into one room and eliminating the dominance of management over the board. This structure will change the relationship between monitoring agents and managing agents from parallel to hierarchical, expanding the range of oversight by consolidating it and avoiding the traditional confusion over the range of monitoring in the Japanese corporate literature.

5. Reforming Corporate Auditors as an Alternative

a. The Cost of Reshaping the Old Image

Theoretically, changing the traditional auditor system to require independence for all corporate auditors may have the same monitoring benefit as requiring true independence for directors. However, there are several factors of concern in Japanese business practice that need to be acknowledged. It may not be easy to change the general perception that the auditor system is functioning well enough, so mobilizing a change to the auditor system may be too challenging. Therefore, it may be simpler and more effective to start fresh and implement a new monitoring mechanism if the cost of changing old images and the confusion occurred in this transition are considered.

b. The Problem of the Current Monitoring Model by the Corporate Auditors

Regardless of implementation issues, whether the traditional corporate auditor system can be considered a satisfactory monitoring system depends on what level of monitoring is expected. In fact, the corporate auditor system can, and indeed has been, doing well in terms of internal auditing, which mainly concerns certifying the correctness of internal accounting.[236] However, when involving

236. In fact there is an alternative voice arguing that Japanese managers are under enough

issues such as suspicious interested transactions, reckless business decisions, manipulation, even fraud or unsafe products, the extent corporate auditors can successfully regulate has met with disagreement. In this sense, if structurally a more direct control to managers is the key, whether the corporate auditor can function as a better monitoring mechanism than the independent director is still doubtful.

c. Other Flaws

An additional flaw in the current corporate auditor mechanism is the nomination process. The nomination of corporate auditors, under the current rules, is initiated by the board of directors,[237] which is in turn controlled by a representative director or CEO.[238] This process compromises auditor independence because auditors must rely on management to attain their position.

The second flaw is that corporate auditors in Japan do not have the right to directly remove managers or directors. The power to remove high-ranking managers is, under the current rules, reserved to the board of directors.[239] Removing a director may be done by a shareholder majority resolution, in most cases.[240] Generally, the power to file a motion in a shareholders meeting, including one proposing the removal of director, is controlled by the board of directors.[241] In this sense, corporate auditors' monitoring capacity is mostly indirect, and, since they are only concerned with monitoring the legality of the board's actions, their powers are only salient when the board is engaged in something illegal.

Third, the parallel structure between directors and auditors makes it extremely difficult to draw a proper line around the range of monitoring while maintaining room for managers/directors' discretion in making business decisions. This

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intra-company monitoring and do not need a further outside monitoring mechanism. NAKAMURA, *supra* note 219, at 17 (arguing managers are working hard already in Japan without any monitoring from the outside, and they know how they are doing by looking at the business, and don't need independent director from outside).

237. The board of directors in Japan has the general power to call a shareholders meeting and decide the agenda and motions to be voted. *See* COMPANIES ACT, *supra* note 15, art 298, para. 1, no. 2. However, the corporate auditor (or board of corporate auditors, if there is one) has the veto right over the nominees proposed by the board of directors. *Id.* art. 343, para. 1.

238. In exceptional situations, a shareholder in a public company who owns either (a) not less than one percent of all voting rights; or (b) 300 voting rights, for more than six months can individually file a motion (which includes the nomination of a director or corporate auditor) for the shareholders meeting to deliberate and vote on. *See id.* art. 303, 305.

239. COMPANIES ACT, *supra* note 15, art 362 para. 2, no. 1, para. 4, no. 4.

240. *Id.* art. 339 para.1.

241. But a minority shareholder also has right to file a motion when certain criteria are met, see *supra* note 223. Also, when a shareholder resolution cannot be obtained, a shareholder who owns three percent of voting right or outstanding shares for more than six months can file a suit for director removal. But this can only be done when director breaches law or articles of incorporation. *See* COMPANIES ACT, *supra* note 15, art 854.

obscurity exacerbates uncertainty if corporate auditors push their monitoring capacity in an aggressive manner.[242]

The differences can be summarized in tables follow:

242. Under the setting of the traditional dual structure, one similar challenge is that the board of the directors and board of corporate auditors have the responsibility of monitoring management, which leads to a duplicity and overlap of the same (or similar) function. *See* KOBAYASHI ET AL., *supra* note 220, at 38.

	Corporate Auditors	Independent Directors
Who Nominates Them?	Nominated by directors/board of directors	Nomination committee can nominate all directors, including independent directors themselves
Choosing Top Managers	No	Yes (By resolution of the board of directors)
Removing Top Managers	No (But when illegal conduct by top managers is spotted, can request director or board of directors to do so or report it to the shareholders meeting)	Yes (By resolution of the board of directors)
Information Right	Yes	Yes
Range of Monitoring	Limited. Focused mostly on accounting and generally not involving the propriety of business decisions if legal	Full. Mostly about major business decisions and choosing audit personnel
Time Spent in House	Long, if he or she is a standing corporate auditor. (But if he or she is designated as an independent auditor, he or she probably will spend a similar amount of time as an independent director)	Short, generally several hours to days a month
Power to Influence Business Decision	No	Yes. Especially when board is smaller, each independent director has bigger decision power (in terms of voting)

Table 9-1: Comparison of Corporate Auditors and Independent Directors (Structure)

	Corporate Auditors	Independent Directors
Restructuring Cost	Lower in theory, but could be similar or even higher depending on the scope of restructuring	High
Potential Opposition From Professional Managers	Low	High (Less high ranking positions available for future promotion)
Fit with Traditional Corporate Group	Slightly less	Better (Less positions to fill and a clearer command line, because directors designated by parent company can be considered to be independent directors by the Japanese definition)
Simplification of Structures and Relevant Rules	No	Yes
Will Require More External/Market or Regulatory Checks?	No substantial difference	No substantial difference

Table 9-2: Comparison of Corporate Auditors and Independent Directors (Implementation and Cost)

6. Summary

Based on the general comparison presented above, the advantage of the independent director mechanism over the traditional corporate auditor system is clear. First, independent directors rely less on management in a single company and have a higher degree of independence. It is not prudent to expect someone to monitor him or herself or a group of people to monitor themselves effectively in the long term.[243] Second, independent directors have better control over the selection and removal of the CEO, possibly the most powerful monitoring function. Third, it has an inherently simpler structure. Since these institutions play similar functions, it makes more sense to choose the one with the simpler structure since it costs less than maintaining a large and complicated organizational arrangement. When compared to traditional Japanese business practice, the single board structure with committees makes it easier to identify who has the

243. In other words, if the distinction between the monitors and the monitored is obscure or when the monitors and the monitored have a strong financial tie or camaraderie, it is less likely the monitoring will be effectively performed.

responsibility to monitor. Merely attempting to reform the corporate auditor mechanism would not have the desired effect that adopting an independent director would.

Judging by history, a structure dividing authority between two boards, as observed in Japan, results mostly in duplicity and redundancy or responsibilities. It does not help improve the monitoring capacity in any obvious way. On the contrary, it weakens the authority not only of the board of directors, but also the corporate auditors. This reestablishment of structural clarity will help to set up a more concrete sense of agency (i.e., supremacy of shareholders) as well as foster responsibility in agents. Once it is established that the board has the authority to run a company, truly effective monitoring, either from the inside or outside, will occur more easily.

C. The Dynamics: Factors Working Against and Supporting Adaptation of the New Corporate Organizational Bodies

Despite its normative advantage over the auditor system and the results of its implementation, the future of the independent director mechanism in Japan is still an open question. However, several factors may well shape the future of this new corporate design.

1. General Counter Factors

The Japanese business world has several reasons for resisting the idea of the independent director and committee structure. The most notable barriers to change are the uncertain costs and the existing cultural framework.

a. The Uncertain Cost

The benefits of adopting the independent director mechanism and the transaction costs incurred in changing corporate structure are one major concern of corporate Japan. Obviously, abandoning the current corporate auditor system is likely to invite strong objection both from the auditors themselves as well as fellow managers who may have had the chance to become corporate auditors. Stopping these objections creates inevitable costs. In the Japanese corporate law literature here is no clear accounting for the size of these costs. But this calculation will differ substantially among companies and can be determined only on the basis of individual company. Without cost estimates, it is unclear to what extent economic factors will have an effect, or if it is simply a red herring.

b. Cultural Issues

In addition to the economic costs, the Japanese resistance to the independent director mechanism is related to the issues of path dependence,[244] mode of

244. *See, e.g.,* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 653-60 (1996) (arguing that corporate governance in Japan is the product of initial conditions and path dependence, or the history of problems that needed to be solved in the past,

competition,[245] and power sharing[246]—all of which have deep roots in Japanese history, politics, and culture. These cultural and historical reasons account, in part, for the slow pace of change in the corporate governance structure. As an example, Japanese culture values harmony and consensus; hence, the relationship between people and companies plays an extremely important role in the Japanese business world. Japan has long been at ease with powerful and centralized institutions, such as large, concentrated, block-holding institutions like the *Keiretsu* and the main banks discussed earlier, or other government-led business coordination. The high value placed on harmony and consensus also helps to explain why Japan allows these large, centralized institutions to do most of the governance work.[247]

Other reasons for the resistance in the independent director mechanism include common Japanese psychological aspects, such as company loyalty and team mentality.[248] The idea of life-time employment remains strong among Japanese corporate officers, and the preference for being part of group rather than working alone contradicts the character of independence and the checks and balances function of the independent director mechanism. Loyalty is fostered by a sense of belonging to a place or a group of people. In this regard, the conflict between "belonging" and "independence" transforms into a dichotomy between "old" and "new", which becomes particularly distinct as traditional values are challenged.

Another issue is the scarcity of proper candidates. Some commentators argue that it is not easy to find enough qualified personnel who are willing to take the job of independent director outside of their profession.[249] Surely the loyalty issue and professionalism may prevent people from taking on too many jobs at the same time. However, these issues may not be as strong as was once thought. The crux is whether the current independent directors can prove they are adequately performing their monitoring functions. If they do, it will attract more qualified people to become independent directors and alleviate the psychological pressure of serving multiple companies at the same time.

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regardless of whether they are still relevant in the present).

245. The reason why competitions among different governance structures or designs are rarely seen in Japan has been one central puzzle to many comparative scholars. One explanation provided by Aoki is that Japanese corporate governance is linked to, and shaped by, its manufacturing techniques. It in turns shape the way corporate governance evolves. For the discussion in this regard, see, e.g., Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1, 6-7 (1990); Gilson & Milhaupt, *supra* note 212, at 345.

246. TAKIE SUGIYAMA LEBRA, JAPANESE PATTERNS OF BEHAVIOR 25, 156-57 (The Univ. Press of Hawaii 1976).

247. Milhaupt, *supra* note 3, at 115.

248. The underlying assumption is that doing other jobs outside your previous company, even when retired, is a kind of "disloyal" behavior since your expertise is the result of accumulated knowledge from previous work experience. In this sense, they share the idea that the accumulated expertise is to some extent a part of the company asset, and should not be available for random personal disposition. For Japanese's collectivism and sense of belonging in general, see TAKIE SUGIYAMA LEBRA, *supra* note 246, at 22-37.

249. *See supra* note 226 and accompanying text.

2. General Supportive Factors

a. The Dissolution of Cross-Holdings among Corporate Groups

Japan's history illustrates that its corporate structure did not evolve according to the Berle and Means paradigm—which claims that economics drive corporate governance. Instead Japan's corporate structure was dependent on and sought to harmonize the relationship between the corporation, its shareholders and its managers.[250]

In the past, the corporate entity in Japan was built on complex, mostly preferential business relationships and cross-holdings among its group members. In this system, a main bank was the center of a corporate group, and it helped to provide funds and liquidity to group members and to coordinate business conduct.[251] Due to cross shareholdings and *Keiretsus*, companies were tied together through a common ownership structure which often involved the primary bank for one or more of the related companies. This ownership structure resulted in shareholders, even large shareholders, being fairly stable and passive. As group members helped to keep a large proportion of shares in stable hands, companies belonging to a corporate group were insulated from outside shareholders and at the same time avoided the possibility of hostile takeovers.[252] In addition, the Japanese government played an important role in corporate governance, and intervened to assist troubled companies.[253] These factors helped create a stable and closed circle of professional managers who controlled corporate Japan.

The economic recession in the 1990s, changed the traditional corporate landscape in Japan. One of the most important changes was the weakening of the corporate groups. After the banking crisis, the banks that survived ceased to provide loans to group members in the same way they had in the past.[254] As a result, more surviving firms formerly belonging to corporate groups became financially independent and moved towards disintermediation, shifting from lending to capital market financing, and internationalizing, all the while retaining their own profit to meet its own capital needs in the future.[255] Firms started to dump shares of other group members if they decreased in value to stop their own losses.[256] These changes attenuated the ties among group members.

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250. Gilson & Roe, *supra* note 56, at 875, 905-06.

251. For a summary introduction to the banking crisis of the late 1990s in Japan, which was the catalyst of many of the following changes, see Mariusz K. Krawczyk, *Changes and Crisis in the Japanese Banking Industry*, in INSTITUTIONAL AND TECHNOLOGICAL CHANGE IN JAPAN'S ECONOMY—PAST AND PRESENT 120, 120 (Janet Hunter & Cornelia Storz eds., 2006).

252. JAPAN REMODELED, *supra* note 50, at 9, 130.

253. Allison Dabbs Garrett, *supra* note 194, at 168.

254. For how the bad debts in the 1990s changed the Japanese financial system and the role of main-banks, see YOSHIKAWA, *supra* note 2, at 51-60.

255. JAPAN REMODELED, *supra* note 50, at 126; Gilson & Milhaupt, *supra* note 212, at 351.

256. This was driven partially by the change to accounting rules from historical value-to-market to market-to-market accounting. This change, which took place in 2000, impaired the

As a result, cross-holding has been reduced substantially since 1995. According to a 2002 study from Nippon Life Insurance Research Institute (NLI), the cross-shareholding ratio of all Japanese listed companies (then 2,674 in number), had dropped from roughly 18.4 percent in 1987, to 17.1 percent in 1995, to 7.4 percent of 2002 on value basis. At the same time, the stable-holding ratio dropped from 45.8 percent in 1987 to 43.4 percent of 1995, then to 27.1 percent of 2002.[257]

Another more recent survey published in 2008, covering 1759 listed companies on three major stock exchanges (Tokyo Stock Exchange, Osaka Stock Exchange and Nagoya Stock Exchange) shows that the cross-holding ratio of stock ownership structure in these companies had reduced about forty percent (a drop from 14.54 percent in 1987, to 10.09 of 2002, and to 8.65 of 2006).[258]

The changes in cross-holding and stable-holding ratios have important effects on the capital structure, mindsets, and business strategies in Japan. For example, because investors have become quicker to sell their shares, company managers must take shareholder demands about share prices more seriously. Also, concerns about the firm's ability to raise more funds from capital markets and the concern about the threat of potential hostile takeovers have become common. In this sense, the weakening of the system of cross-holdings has changed a fundamental feature of traditional Japanese corporate governance. The impact of these changes became more obvious as the economy started to recover.

The relationship between the changes to the cross-holding structure and to the management structure still requires further observation. Commentators argue that the *Keiretsu* still exists, though they are weakening, and the management system is still under the dominance of insiders.[259] Moreover, the broad definition of

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value of company assets by forcing firms to report portfolio losses. JAPAN REMODELED, *supra* note 50, at 88-90.

257. Fumio Kuroki, NLI Research Institute, *The Relationship of Companies and Banks as Cross-Shareholdings Unwind---Fiscal 2002 Cross-Shareholding Survey*, 6 fig. 3 (2003), *available at* http://www.nli-research.co.jp/english/economics/2003/eco031118.pdf (last visited Mar. 28, 2010).

258. Keisuke Nitta, NLI Research Institute, *Corporate Ownership Structure in Japan—Recent Trends and Their Impact*, 4 (2008), *available at* http://www.nli-research.co.jp/english/economics/2008/eco080331.pdf (last visited Mar. 28, 2010). It is noteworthy that the samples and definition in these two surveys, though conducted by the same institution, are not identical. These differences lead to major difference in the ratio numbers. But the long-term trend of downsizing and the substantial size of reduction (roughly forty percent) are observed in both surveys.

259. *See* Andreas Moerke, *Japanese Inter-Firm Relations---On the Way Towards a Market-Oriented Structure? in* INSTITUTIONAL AND TECHNOLOGICAL CHANGE IN JAPAN'S ECONOMY----PAST AND PRESENT 85, 85-87 (Janet Hunter & Cornelia Storz eds., 2006). Also, the latest research indicates a resurgence of cross-shareholding, which is mostly attributed to the need to fend off unsolicited takeovers. Keisuke Nitta, Research Institute of Economy, Trade and Industry (RIETI), *Unwinding of Cross-Shareholding and Beyond* (May 9, 2007), http://www.rieti.go.jp/en/projects/cgp/columns.html (last visited Mar. 28, 2010). In fact, in 2009, newspapers reported that the ratio of cross-holding the Japanese companies has slightly risen in the last three years. Kudou Akihisa, *Kabushiki Mochiai: Sannen Renzoku De Zouka Shuueki*

independent director in Japan can be used to facilitate the organization of corporate groups.[260]

b. The Liberalization of Employment Relationships and the Weakening Idea of "Life-Time Employment"

Japan has traditionally been proud of its long-term employment guarantee.[261] The long-term employment guarantee was considered to be an important element in Japan's economic system, which complements the national system of economic governance along with the financial and political system.[262]

However, this time-honored practice faces severe challenges since the economic recession of the 1990s. Prolonged stagnation and mounting pressure triggered several structural changes. The employment rates in this period demonstrate how long-term employment was effected.

Year	1985	1990	1995	1996	1997	1998	1999	2000
Percentage	2.6	2.1	3.2	3.4	3.4	4.1	4.7	4.7

Year	2001	2002	2003	2004	2005	2006	2007	2008
Percentage	5.0	5.4	5.3	4.7	4.4	4.1	3.9	4.0

Table 11: Unemployment Rate in Japan[263]

Generally, when dealing with economic recessions and the pressure to cut costs, companies in Japan first mobilize employees to increase productivity or transfer employees to other, healthier branches. If those methods fail, then companies will cut wages and reduce working hours or transform employee status to low-cost "temporary" employees. If all of the above fail, managers consider layoffs and plant closures. In Japan, layoffs are generally believed to hurt the company's image and impair its ability to recruit new employees in the future.[264]

Akka No Ichiin Ni— Sakunendo Matsu (Cross-Holding: Increasing Three Years in a Row, Part *of The Reason of Decreased Profit—The Result For End Of Last Year)*, MAINICHISHINBUN (DAILY NEWS), July, 3, 2009, *available at* http://mainichi.jp/select/biz/news/20090703ddm008020048000c.html (last visited Mar. 28, 2010).

260. Gilson & Milhaupt, *supra* note 212, at 364-65.

261. For a general discussion of Japanese traditional lifetime employment, see MASAHIKO AOKI, INFORMATION, INCENTIVES AND BARGAINING IN THE JAPANESE ECONOMY, 60-69 (Cambridge Univ. Press 1988).

262. *See, e.g.*, Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508, 508-40 (1999).

263. STATISTICS BUREAU OF MINISTRY OF INTERNAL AFFAIRS AND COMMUNICATIONS, JAPAN STATISTICAL YEARBOOK, *available at* http://www.stat.go.jp/data/roudou/longtime/03roudou.htm (Long-Term Series Chart 2) (last visited Mar. 28, 2010); *Japan Institute for Labor Policy and Training, Unemployment and Employment Insurance*, *available at* http://www.jil.go.jp/english/estatis/eshuyo/200907/e0206.htm (last visited Mar. 28, 2010).

264. For a detailed depiction of how Japanese companies dealt with the transitional period of traditional labor management wisdom, see JAPAN REMODELED, *supra* note 50, at 115-17.

For some companies belonging to a corporate group, they may be able to call on their main bank to obtain more credit or work with suppliers to reduce procurement costs. However, these alternatives became less viable because too many companies were requesting bailouts after Japan's economic recession in the 1990's.[265]

In this economic atmosphere, the traditional corporate loyalty and long-term employment commitment gradually weakened. The increasing closure of businesses and rising unemployment triggered a feeling of insecurity among employees and pressured managers to do what they could to keep companies afloat. This in turn led to a more liberal attitude toward employment relationships among both employers and employees.[266]

Along with the economic recession of the 1990s and the restructuring of businesses came the advent of new types of businesses, such as the high-tech and telecommunications industries. Although these new industries created the need for new and different types of skilled labor, this demand could not be met with the unemployed labor force. The mismatch between labor market demands and labor force surpluses was further emphasized by technological innovations.[267] The changes in industry, both in structure and content, as well as the insufficient labor demand in traditional industries, increased labor market volatility.

The economic recession and resulting volatility led to a change in mentality and softened the traditional ideas of lifetime employment and corporate loyalty. The weakening notion of life-time employment and increasing mobility will provide more qualified personnel for the job of independent director, and help to shape a new sense of corporate loyalty. The new conception of loyalty will not be to a CEO or a vague idea of "corporation," but to investors and shareholders.[268] This change could help create a friendlier environment for the independent director in Japan.

c. Accounting Reform After Major Corporate Scandals

In addition to revisions to the Commercial Code and the enactment of the Companies Act—allowing Japanese companies to operate using American-style boards of directors—Japan is also following the lead of the United States in crafting reforms in the areas of accounting and auditing. Japan's Financial Services Agency's Subcommittee on Certified Public Accountant Regulation has recommended taking steps to enhance auditor independence, such as limiting non-audit services and rotating audit staff, as well as working to increase the number of

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265. For a discussion of the different types of unemployment and its breakdown and the changes brought by unemployment, see YOSHIKAWA, *supra* note 2, at 141-44.

266. However, one commentator argues that long-term employment has not changed as substantially as it has appeared because most unemployment increase came from non-regular work in the short terms while most Japanese firms still preserve their long-term employment system. JAPAN REMODELED, *supra* note 50, at 119.

267. YOSHIKAWA, *supra* note 2, at 144-46.

268. *Id.* at 146-50.

accountants in Japan.[269] Stronger regulation of the accounting industry is also among the proposed reforms, and led to the "Financial Instruments and Exchange Act" which contains many rules similar to those in the Sarbanes-Oxley Act of the United States. In fact, the law has been dubbed J-SOX, an acronym for the Sarbanes-Oxley Act.[270]

The passage of the Sarbanes-Oxley Act was an important catalyst for these changes in the fields of accounting and auditing. The influence of the Sarbanes-Oxley Act in Japanese corporate circles was two-fold. On the one hand, it triggered more domestic accounting reform proposals. On the other hand, many Japanese companies who trade their securities (either directly traded on U.S. stock exchanges or in the form of American depositary receipts) were thereby directly regulated by U.S. securities regulations, which required higher auditor independence and that independent directors play a prominent role on the board. The desire to trade in multiple markets urges a more open attitude for independent director mechanism.

The adoption of stricter accounting rules and reporting obligations are not without problems. There are concerns about the time committed and financial resources spent on rule compliance, and a fear of negative effects on corporate earnings and listings expressed by Japanese companies who comply with U.S. securities regulations.[271]

d. The Advent of Hostile Takeovers

In 2003, Japan's economy started to show signs of recovery from its more than decade-long recession. The business landscape was being shaped by new dynamics. Some companies that survived the downturn of the 1990s started to recover and gain comparative advantage as a result of restructuring and adaptation. Many other companies were still suffering from low share price, some below their asset values.[272] Corporations and investors started to accept the idea that hostile

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269. Michael Solomon Associates, Inc., *Regulatory Watch: A Blueprint for Accounting Reform in Japan: Blue-Ribbon Panel Releases Its Recommendations to the Financial Services Agency*, 4 JAPAN CORPORATE GOVERNANCE REPORT 3 (Jan. 2003), *available at* http://www.msapr.com/pdf/JCGReport_Jan03_English.pdf; Allison Dabbs Garrett, *supra* note 194, at 168-69.

270. Financial Instruments and Exchange Act was enacted in June 2006, and started to take full effect in September 2007, as some rules in it have a different effective date. Basically, this law is designed to amend and replace the Securities and Exchange Act and other financial laws, and to provide a more comprehensive protection to the investor public and renew the framework of financial market regulation. For an official introductory discussion of the Financial Instruments and Exchange Act and a compilation of related materials, see Financial Services Agency, Financial Instruments and Exchange Act, *available at* http://www.fsa.go.jp/en/policy/fiel/index.html (last visited Mar. 28, 2010).

271. *Stricter U.S. Accounting Rules Delay Sony Earnings*, THE NIKKEI WEEKLY (JAPAN), Mar. 12, 2007; *Cost of Integrity a Heavy Burden*, THE NIKKEI WEEKLY (JAPAN), Feb. 26, 2007; *Tougher Auditing Standards Put Damper on Listings*, THE NIKKEI WEEKLY (JAPAN), July 18, 2007.

272. In a survey of the market capitalization of 779 non-financial firms traded in Tokyo

merger and acquisition would help corporate assets to flow to more productive uses and increase economic efficiency. The series of amendments to the Commercial Code between 2000 and 2003 also encouraged corporate restructuring by permitting various means such as share buy-back, stock options, and the issuance of a special class of shares with veto power in electing directors.[273]

Together, these factors have created a more favorable environment for takeovers. Japan started to experience an unprecedented boom of mergers and acquisitions starting around 2000. The pace of merger activity in Japan, which had been hovering at around five-hundred transactions a year in the 1990s, began to pick up around the end of that decade to reach an annual volume of 2,725 transactions in 2005. This represented a five-fold increase in merger and acquisition transactions over a ten-year period.[274]

In general, takeovers in Japan were not welcome before this merger and acquisition wave. Though the reasons may be multiple and complicated, people in Japan traditionally tended to consider mergers and acquisitions neither a regular business activity for the business world as a whole, nor a normal business strategy at the individual company level. This held especially true for hostile takeovers. However, in the last several years, takeovers have become more common in Japan and the law has successfully evolved to reflect a more or less neutral, possibly welcoming, attitude toward hostile takeovers.[275]

Stock Exchange in 2000, Prof. Curtis Milhaupt recorded approximately 13 percent of these firms were trading below their bust-up value. In other words, more than one of every eight public firms in Japan in that year was worth more in liquidation than under current management. Milhaupt, *supra* note 3, at 108.

273. In terms of hostile takeover bids, the broadened compensation options for mergers and acquisitions and permitting triangular mergers (which started in 2006 May) has helped clear many legal barriers. *See also* Hideki Kanda, *Does Corporate Law Really Matter in Hostile Takeovers?: Commenting on Professor Gilson and Chancellor Chandler*, COLUM. BUS. L. REV. 67, 71-72 (2004).

274. Yasuhiro Arikawa & Hideaki Miyajima, *Understanding the M&A boom in Japan: What drives Japanese M&A?*, REITI DISCUSSION PAPER SERIES 07-E-042, 2 (2007), *available at* www.rieti.go.jp/jp/publications/dp/07e042.pdf (last visited Mar. 28, 2010). In 2006 and the first half of 2007, the number of M&A deals remained at a similar number (1315 deals in the first half of 2007, which worth of about US$69 billion, compared with $63.5 billion in 1327 deals in the first half of 2006). *See* PRICEWATERHOUSECOOPERS, ASIA-PACIFIC M&A BULLETIN: MID-YEAR 2007: JAPAN, *available at* http://www.pwccn.com/home/webmedia/633214790690971488/m&abulletin_ap_mid2007_jp.pdf (last visited Mar. 28, 2010).

275. A joint survey in October 2006 conducted by the Japan Center for Economic Research and The Nikkei Financial Daily covered 178 companies , most of which are publicly traded non-financial firms and have taken some merger-and-acquisition steps during the preceding ten years. About sixty percent of the investigated companies take a favorable view of hostile takeover bids against other domestic firms. In particular, for the question of what they "think about making a hostile takeovers against another domestic company," with multiple answers allowed, 41.2 percent picked "There are cases where a hostile bid is unavoidable," and 30.6 percent answered that "Hostile bids should no longer be judged negatively." If an overlap in responses is taken into account, 61.2 percent showed a positive attitude toward hostile takeovers. *Majority of Firms for Hostile Takeovers*, THE NIKKEI WEEKLY (JAPAN), Oct. 30, 2006. In another survey of the

This change provides a favorable environment for the use of the independent director in Japan. The rise of hostile takeovers forces many companies to adopt varying defense measures, including U.S.-style rights plans. Generally, United States corporate law is greatly influenced by Delaware law and Delaware jurisprudence incentivizes greater use of the independent director as a balancing mechanism.[276]

An example of Japanese firms using U.S.-style rights plans was seen during the shareholders meeting season of 2007. According to a survey conducted by Nikkei Inc., two-hundred and twenty-two companies aimed to introduce a takeover defense that can delay tender offers by requiring suitors to explain their prospective business plans. These two-hundred and twenty-two firms account for eight percent of all companies that hold their general shareholders meetings in June.[277] At the same time, shareholder activists and proxy advisers are also urging companies to have more independent directors on the board and allow committees comprised of independent directors to review defense measures before they are proposed at the shareholders' meeting.[278]

Debates about how to pursue a takeover strategy, and specifically how to defend companies from unwelcome takeover bids, have taken center stage in discussions of Japanese corporate law literature.[279] The discussion has increased rapidly in recent years. Japanese managers are struggling to make the choice between giving up part of their power to outside directors or face the threat of losing all managerial power to hostile suitors. It is undeniable, however, that the rise of hostile takeovers and their countermeasures have encouraged the implementation and use of the independent director in Japanese corporate governance. How much actual change this hostile M&A wave will result in remains to be seen, but the trend warrants close and careful observation in the future.[280]

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presidents and chairmen of major corporations, conducted in July and August 2006 by Nihon Keizai Shimbun Inc, a leading Japanese economic newspaper, 71.4 percent said they would consider M&As given an attractive proposal. Another 4.5 percent said they would enthusiastically consider an M&A plan if it were amicable, and 0.8 percent said they would weigh a hostile takeover if necessary. All told, 76.7 percent perceive M&As as a possible business strategy. *Growth To Last Over Year: 42% of Execs,* THE NIKKEI WEEKLY (JAPAN), Aug. 14, 2006.

276. *Cf. Outside Directors Taking on Watchdog Role*, THE NIKKEI WEEKLY (JAPAN) June 20, 2005.

277. *Firms Seek Takeover Shield*, THE NIKKEI WEEKLY (JAPAN), July 18, 2007.

278. *Id*.

279. In another article, it is reported that nearly 400 companies have adopted poison pills between May and June in 2007. *In the Locust Position; Shareholder Activism in Japan*, ECONOMIST, Jun. 30, 2007, at 80.

280. It is noteworthy that the Ministry of Economy, Trade (METI) and the MOJ jointly issued "*Guidelines Regarding Takeover Defense for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests*" in 2005 (sometimes referred in short form as "Takeover Guidelines"), *available at* http://www.meti.go.jp/policy/economic_oganization/shishin_ sakutei.html (last visited Mar. 28,

e. Derivative Suits

When compared to how the independent director mechanism functions in the United States, an important part missing in Japan is the availability of shareholder derivative suits.[281] In the Unites States, derivative suits and the independent director mechanism are tightly connected and supplement each other. In this way the independent director mechanism is used to countervail aggressive derivative suits by performing a balancing function between managers and shareholders.[282]

However, in Japan, derivative suit jurisprudence is still developing.[283] As a central piece of private enforcement, derivative suits have the potential to perform a more important role in Japan, especially when both the internal control within firms and other external control proves insufficient.[284]

Derivative suits do not come without a price. First, they require the help of experienced lawyers to organize a successful suit, which may not be always available. Second, shareholder suits that are too aggressive may unduly interfere with management and in turn become detrimental to efficiency, and ultimately to shareholders' interests. However, independent directors can operate as a safety valve to mitigate the potential misuse of shareholder derivative suits by balancing managerial discretion with shareholders' rights to challenge those decisions.[285]

2010). The Takeover Guidelines recommend a three-prong test for determining whether a takeover defense is reasonable; the test is patterned on the Delaware Supreme Court's *Unocal* standard. A defense will be deemed "reasonable" when: (1) the takeover poses a genuine threat to corporate value; (2) the chosen defensive measure is proportional to the threat; and (3) the selected defensive measure is taken by the board in an independent manner. In terms of the organizational aspect, it is expressly requested that the adoption of an anti-hostile takeover measure be conducted by the board in an independent manner. Though not legally binding, the Takeover Guidelines have a clear influence over the court's view in deciding cases with similar scenarios, and are widely expected to play a substantial role in shaping Japan's hostile takeovers landscape. However, there are different opinions about how the hostile takeovers wave and the relative vacuum in legal standards in Japan will interact in the future. Professor Hideki Kanda at University of Tokyo proposes that it may lead to more governmental involvement. It will then create more regulatory-style doctrines and leave less room for courts and individual companies to decide which level of anti-hostile takeover defense is preferable and legally feasible. *See* KANDA, *supra* note 11, at 72-75. *Cf.* Curtis J. Milhaupt, *Prescribing the Pill in Japan?: Foreword to the Hostile M&A Conference Issue*, COLUM. BUS. L. REV.1, 7-8 (2004). For a contrary opinion about a heavier role for the court and independent directors, *see* Ronald J. Gilson, *The Poison Pill in Japan: The Missing Infrastructure*, COLUM. BUS. L. REV. 21, 33-36 (2004).

281. For a discussion of shareholder litigation in the 1990s, see *supra* note 12.

282. *See generally* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1523-28 (2007).

283. *See generally* Mark. D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351 (2001).

284. *See* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1604-07 (2005) (discussing the symbiosis between private and public enforcement in corporate law).

285. *See* Gordon, *supra* note 282, at 1523-28.

In the face of fundamental changes to Japan's economic environment, shareholder activism intensifies the motivation to change corporate practice.[286] These changes, including the threat of shareholder litigation, create a better chance for the independent director mechanism to develop in Japan. Whether this dynamic between shareholder litigation and independent director mechanism can happen largely depends on the view of domestic courts. Currently, the standard of directorial liability in Japan (for both independent directors and other insider directors alike) is akin to negligence.[287] As such, directors in Japan are more likely to be found liable in the name of violating the law or corporate charter when compared to parallel situations in the United States. If courts express deference to judgments made by independent directors, it will increase the incentive for management to have more independent directors on the board. In this sense, a real independent board may help earn a more preferential treatment from the courts and make shifting to the one-board system more appealing.

V. CONCLUSION

At first glance, the Japanese traditional two-board system appears to be persevering in the face of challenges from the independent director mechanism and committee structure since its first inception in 2002. Upon deeper reflection, however, it becomes clear that this traditional system is inadequate for the task at hand and the increased use of the independent director in Japan seems likely, even necessary, because it offers the following advantages: better control over CEO selection and removal, structural clarity, and, if the cost of shifting to new design and resistance from corporate auditors and other managers can be overcome, an increase in shareholder value.

This article explores the recent cultural and economic changes and demonstrates why these changes are likely to provide a better environment, and impetus, for greater use of the independent director mechanism. The "cultural explanation" for adhering to the traditional system has lost its relevancy and is not as convincing today. The decline of the cultural explanation can be attributed to the growing discontent with self-entrenched managers and inadequate monitoring, the demand for a better intra-firm monitoring mechanism, and the change of background structures as the result of post-recession economics.

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286. It is noteworthy that an increasing number of large corporate law firms in Japan in recent years which actively advice business. *See* Bruce Aronson, *The Brave New World of Lawyers In Japan: Proceedings of a Panel Discussion on The Growth Of Corporate Law Firms and the Role of Lawyers in Japan*, 21 COLUM. J. ASIAN L. 45, 77-78 (2007) (reporting the existence of a substantial number of lawyers in the plaintiffs' bar for shareholders litigation in Japan and the lack of class actions, substantial discovery, and equitable remedies limits its growth).

287. Directors in Japan have a duty to manage their companies with good care ("zen kan chuui gimu"), COMPANIES ACT, *supra* note 15, art 330; MINPO (CIVIL CODE), art. 644) and loyalty ("chuujitsu gimu") COMPANIES ACT, *supra* note 15, art 355, duties which are similar to duty of care and duty of loyalty in U.S. law. *See* LAWS OF STOCK CORPORATIONS, *supra* note 117, at 428 (general negligence standard applies).

At this point, Japan's experiment with the independent director mechanism seems to be on a different path from its experiment with one-board structure. The former enjoys steady growth while the latter suffers from embarrassing stagnation. The issue is complicated further by the troubling fact that Japanese corporate law has struggled to find a better solution to the problem of inadequate monitoring. Therefore, it is still too early to confidently pinpoint what direction the Japanese independent director mechanism will take in next decade. Clearly, corporations' perception and application of this mechanism are essential to its future development. Legal scholars should monitor the progress of the independent director mechanism in Japan for the lessons it provides us about the complexities of legal transplants.