Japanese Independent Director Mechanism Revisited: The Corporate Law Setting, Current Status and Its Explanations

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The Corporate Law Setting, Current Status and Its Explanations

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## I. INTRODUCTION

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I. INTRODUCTION

Japanese corporate governance, or in a broader view, Japanese capitalism, possesses several distinct attributes. Some of the often-mentioned are powerful bureaucracy, close government-industry ties, the main bank system, lifetime employment, and dense inter-firm networks. In a brief word, it includes many long-term relationships, such as with workers, banks, suppliers, other firms and even government. These distinct attributes of the Japanese model and its deviance from the typical industrial capitalism represented by the Anglo-American style of corporate governance make it a target of great interest for both academics and practitioners.

In the opposite, it is noteworthy that dramatic changes have occurred since the 1980s. Following first the frenzy of “learning from Japan” that started in the 1980s and then the end of the economic miracle and subsequent recession in the 1990s, more and more people began to ask about the relationship between the initial strength and later weakness of Japanese corporate governance. In the quest to reverse the downward trend, policy reform was initiated and many new rules were implemented, which dramatically changed the landscape of Japanese corporate governance. But the result of these reforms is still unclear. Several elements compound the so-called 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 introduction of the institution of independent director in Japan is a move that 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 lacking in oversight capabilities. The need for reform became more apparent during the economic malaise that began in the early 1990s. By late 1990s, momentum was building for a complete overhaul of the traditional governance model, and the independent director, considered to be a distinctive characteristic of American corporate governance, was the chosen cure.

On the other hand, it is puzzling because the independent director, as a design, contradicts most of the values characterized by Japanese corporate governance, which had 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 American corporate governance.
At the first glance, the series of amendments in the 1990s and early 2000s in Japanese corporate law took two approaches: deregulation to reinvigorate corporate energy and enhancement of monitoring capabilities to curb corporate misconduct. Though conceptually distinct, both approaches at times pointed to a more U.S.-style governance as the solution. As for the case the independent director mechanism, legislative material shows it was expected to facilitate enhanced monitoring. In fact, there had been a series of amendments to Japanese corporate law since the 1970s to reinforce monitoring. It was, therefore, not a surprise to have this new addition, especially in light of increasing corporate misconduct. Support for this new mechanism gained momentum in 2002 as the anticipation of U.S.-style governance reached its peak and the confidence in Japanese corporate rules reached its lowest levels. However, as the following discussions will show, the independent director mechanism, accompanied in Japan by the introduction of the committee type company, has faced doubts and hence few adherence in Japan since its formal introduction in 2002.

This article is structured as follows. Part II first sets out necessary background concerning Japanese corporate law today, including its basic organizational rules, amendments in recent decade including 2002 Amendment, and the structural reasons behind these amendments. Part III focuses on the adoption of the independent director mechanism in Japan, and discusses how it is conceived, its implementation and current status. Part IV then analyzes why this new institution encounters difficulty in Japan and discusses the possible dynamics shaping its future direction. I argue that a more extensive use of the independent director mechanism in Japan would better meet the demands of a fast-changing environment and review the normative grounds for board independence and a simpler governance structure, especially in light of its comparison with traditional dual board structure with corporate auditors. Part V concludes.

II. GENERAL BACKGROUND OF JAPANESE CORPORATE GOVERNANCE

1. Brief History of Japanese Corporate Law

Historically, the law that governs corporate governance in Japan was almost entirely imported. The first generation of Japanese corporate law, the Commercial Code, which supplied the basic rules for corporate formation and conduct, was originally
based on Germany's model and imported during the end of 19th century. Later, after World War II, American influence became the most important factor shaping the landscape of Japan's corporate law.

The Commercial Code of Japan was first promulgated in 1890. That version 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 met with a flurry of criticism, which delayed its enactment. A revised version of the Commercial Code, still partly in effect now, was finally adopted in 1899. This version moved away from the French model and was primarily modeled after the German Commercial Code (Handelsgesetzbuch) of 1897.²

The Commercial Code had been the primary source of corporate law in Japan until 2005 since then. Commercial Code was divided into five parts: General, Company, Commercial Transaction, Merchant Shipping and Insurance. The Company section covered joint stock companies as well as general partnership and limited partnerships. There was a separate law for limited liability companies (the Limited Liability Company Law).² 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 (Zeibatsu) successfully thrived.

The second generation of Japanese corporate law emerged after World War II. U.S. authorities extensively modified the Commercial Code during the occupation of Japan as part of the agenda to reform Japan's political and economic structure. As a result of the U.S. occupation, Japanese securities law is modeled after the federal securities law of the United States.³ In 1950, Part Two of the Commercial Code (Company Law) was substantially amended, and several important changes were made thereafter. First,

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² The reason why the Limited Liability Company Law was made a separate law is because this type of company (Gesellschaft mit beschränkte Haftung) was invented in Germany after the enactment of the Commercial Code. The Limited Liability Company Law was introduced in Japan in 1938. Id. at 131, 216.
the system of authorized capital was introduced together with non-par shares. Second, the powers of directors were expanded, reducing the power of the general meeting of shareholders. At the same time, the board of directors, to which directors are elected by the shareholders to serve as the governing unit of the corporation, was introduced and the liability of directors increased. Third, the rights of the shareholders were expanded so that they could exercise control over the management of the company. Thus, during the post-war reform, U.S. institutions were introduced into the primarily German framework.

The Company Law Part of Commercial Code had undergone a number of major amendments since the 1950 Amendment, and many of which were in response to developments in U.S. corporate law and practice. Two important amendments were introduced in 1974 and 1981 respectively. In 1974, the Law on Special Measures to the Commercial Code on Audit and Related Matters was enacted. It differentiated the level of auditing requirements according to company size and enhanced auditing rules for large companies. Later, 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. Partly as result of the increasingly close economic ties between the United States and Japan, many of those corporate law amendments were, formally or informally, the result of strong U.S. influence.

2. Amendments in the 1990s and the Advent of the Companies Act of 2005

Although there were several amendments during the 1970s and 1980s, the frequency of Commercial Code amendments has increased since the 1990s. In general, the major goal of the amendments in this period was to enhance the protection of shareholders’ rights. In the 1993 Amendment, both the issues of derivative suit and

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4 ShoHo (Commercial Code) art. 245, para 1.
5 Oda, supra note 1, at 132.
6 Id. at 217.
7 For an introductory discussion of the amendments to the Commercial Code since the 1990s, see Hideki Kanda, Kaisha Ho (Companies Act.) 31-37 (11th ed. 2009).
8 Commercial Code Amendment of 1993, Act No. 62 of 1993. (All amendments of the
the right of shareholders to inspect account books were addressed. The fee for filing a
derivative suit was a flat 8200 Japanese Yen if the target of litigation did not
exceeding 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 (i.e., 13000 yen
now) applies. This substantially lowered the threshold for shareholders to bring
derivative suits. And if shareholders win in their derivative suits, they can require full
reimbursement for any attorney fees paid from company. Further, the qualification for
requesting to review accounting materials and books was lowered from holding more
than 10 percent of the outstanding shares to 3 percent. Also, the term of corporate
auditors was extended from two years to three years. For those companies that qualify
as a “Large Company”, they need to have more than three corporate auditors and at
least one of them must be an outside auditor. The 1993 Amendment also introduced
the board of auditors and shifted the power of individual auditors to the board of
auditors. Finally, this amendment overhauled the rules concerning corporate bond and
removed the cap of the amount of corporate bond a company can issue.

In 1994, the Commercial Code was further amended to liberalize the company’s
power to purchase its own shares. For example, 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.

Commercial Code are incorporated as part of the whole text when passed, and the original articles are
removed).

9 LAW ON CIVIL LITIGATION FILING FEE, art. 4, para 2.

10 Companies with more than 500 million yen in capital and 20 billion in liability are classified as
“Large Companies.” This rule is inherited in the COMPANIES ACT, of 2005. For the definition, see
COMPANIES ACT, art.2, para1(6).

11 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 without difference in connotation in use both in English and
Japanese, hereinafter “independent director” will be used as the English translation for “shagai
torishimariyaku (outside director)” in Japanese. See but, Donald C. Clarke, Three Concepts of the
Independent Director, 32 DEL. J. CORP. L. 73 (2007) (Arguing there are differences between the uses
of independent, outside, and disinterested directors, and that these manifestations serve different
purposes and should not be confused with each other).

There were multiple amendments in 1997. The most important change was the introduction of stock options. Also, the procedure of merger among companies was simplified. In addition, side payments to shareholders as a means to ensure a smooth and speedy shareholder meeting were prohibited.13

The 1999 Amendment14 involved the introduction of the mechanism for stock swap. This mechanism was the result of the lift of the ban on holding companies in the Anti-Monopoly Law of 1997. This law allowed companies to surrender all of its shares and become a subsidiary of another company. It was considered as a step further toward liberalization of corporate mergers and acquisitions. In 2000, rules concerning corporate division and stock options were amended.15 Rules concerning the short form asset transfer were also introduced. Notably the irregular transactions between parent and subsidiary, especially those without reasonable considerations, were prohibited.

There were three amendments to the Company Part of the Commercial Code in 2001 as well as a new law relating to short-term corporate bond issuance and exchange. First, in the amendment of June 2001,16 the Commercial Code was amended to allow companies to acquire their own shares freely without any conditions. It also repealed the rules concerning the basic unit of shares and their face value. The process of issuing shares was also further simplified in this amendment. The November 2001 amendment17 concerned two important areas. First, it aimed to further liberalize the issuance of classified stocks and allowed issuing shares with limited voting power, along with other rules on exercising convertible bonds and issuing new stock for a specific third party. The second part in this amendment concerned the extensive use of electronic format in corporate bookkeeping and notification (including permitting directors cast their vote via phone or other electronic devices). Generally speaking, the prior consent is necessary if a company wants to use electronic means to send notice or similar notification which may affect the right of the receiver.

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The third amendment in 2001\textsuperscript{18} concerned the enhancement of governing institutions. Two important rules were involved in this amendment. First, the term of corporate auditors was extended to four years. Second, for those corporate auditors serving in a “Large Company”, the qualifications of outside corporate auditor were further tightened, and this amendment required that half of the corporate auditors serving in the “Large Company” must be outside auditors. Third, interestingly, this amendment also alleviates the liabilities of directors and auditors by setting a cap on the amount of damage if certain conditions are met. It is generally considered an attempt to pacify the anger of the business community, which has been dealing with increasing shareholders’ derivative suits since the mid-1990s.

In 2002, the \textit{Commercial Code} was again extensively amended.\textsuperscript{19} The most important change brought in this amendment was the introduction of the one-board structure (the “committee structure company”). The amendment also outlined the following changes: further loosening of the quorum requirement and related procedure of the shareholder’s meeting; revised rules concerning the right to vote on the election of directors and corporate auditors by classified shareholders; expanding the rules of asset evaluation, alternative forms of capital infusion, and reducing capital, etc. The law concerning short-term corporate bonds was amended and expanded to cover all corporate bonds, and the relevant trading rules were also amended extensively.\textsuperscript{20}

In 2003, the law was again amended to limit companies’ ability to buy back their own stock only to cases when this authority is stipulated in the articles of incorporation and is based on the resolution of the board of the directors.\textsuperscript{21} In 2004, several rules were amended.\textsuperscript{22} First, the use of electronic bulletin systems was stipulated and encouraged and at the same time the extent of information to be publicized was restricted to alleviate the burden of publication which was generally considered to be onerous. Second, both stocks and corporate bonds were encouraged to become electronic and several rules in this regards were supplemented.\textsuperscript{23}

\begin{thebibliography}{99}
\bibitem{18} \textsc{Commercial Code Amendment of 2001}, Act No. 149 of 2001.
\bibitem{19} \textsc{Commercial Code Amendment of 2002}, Act No. 44 of 2002.
\bibitem{20} \textsc{Amendment of Corporate Bond Exchange and Transferal Law}, Act No. 65 of 2002.
\bibitem{21} \textsc{Commercial Code Amendment of 2003}, Act No. 132 of 2003.
\bibitem{22} \textsc{Commercial Code Amendment of 2004}, Act No. 87 of 2004.
\bibitem{23} For a brief list of amendments to the Commercial Code in recent years, see also Curtis J. Milhaupt, \textit{A Lost Decade for Japanese Corporate Governance Reform?: What’s Changed, What Hasn’t, and Why}, in \textsc{Institutional Change in Japan} 97, 98(Magnus Blomstrom & Sumner La Croix eds., 2006), available at SSRN: \url{http://ssrn.com/abstract=442960}.
\end{thebibliography}
All these amendments above were only pieces of a bigger agenda. After many years of contemplation and deliberations, the Japanese cabinet was able to bring the *Companies Act* in 2005, which replaces the *Company Part* of the *Commercial Code* and other related legislation. Generally speaking, the voluminous *Companies Act*, along with the supplementary rules concerning its implementation, is designed to integrate all tenuous pieces of legislation in the area of corporate law which had been produced since the Second World War and to reorganize them into a consolidated form. Through these means, differences in legislation could be coordinated and the laws as a whole would in turn become more comprehensive.

In addition to the desire to improve legislation in terms of format, several aspects of a substantive manner were also addressed in this new law. The primary goal of *Companies Act 2005* is to enhance the flexibility of regulation, and hence provide more mobility for business management. This is carried out in several ways. First, to encourage corporate reorganization as well as mergers and acquisitions, the several procedures and relevant rules are further simplified and companies are allowed to use more flexible means to finance their mergers or reorganizations, including exchanges between different classes of stock. Second, to facilitate corporate capital-raising, the rules relating to corporate bonds are again modified and management starts to enjoy more discretion and flexibility in issuing corporate bonds. Third, regarding the type of company, the new *Companies Act* integrates the limited company and the stock company into a single form (the "Stock Company") and repeals the minimum capital requirement. It also adds limited partnership to the menu of companies. Last, to improve the quality of business management, the rules governing derivative suits are revised and a lower liability standard is applied to directors in derivative suits (down from strict liability). Also, for Large Companies, internal organizational designs become more clearly defined, and the need to improve accounting accuracy and inspection is also addressed.

From a broader view, the *Companies Act of 2005* is a part of a continuous endeavor which intends to change the highly regulatory style in Japanese economic landscape. It stresses the need for the delegation of power to management to deal with the

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24 *KAISHA HO (COMPANIES ACT), Act No. 86 of 2005*[hereinafter COMPANIES ACT]. This act was promulgated in July 26, 2005 and most of its 8 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. [http://www.japaneselawtranslation.go.jp](http://www.japaneselawtranslation.go.jp)
challenge of increasing competition on a global scale as well the aftermath of the long economic malaise in the bubble era of the 1990s. This change substantially reflects the general perceptions of the academic and business circles as well as that of the public. But under this theme, there are still many unsolved conflicts. For example, the resurrected tightening rules of derivative suits partially mirror managers’ desire for larger safe zone in the face of the general trend of “de-regulation.” But, on the flip side, corporate misconduct is still the major concern, and new rules about accounting audits highlight this concern. The solution conceived reflects the preference for setting up new corporate organs in Japanese corporate legislation. Thus, the reliance on organizational rules is facing both pushes and pulls in Japan, which in turn raise complex questions about the mandatory or voluntary approach to legal change in corporate law, and the role of the organizational design in it.

3. Changes in the 1990s: Background, Challenges and Aftermath

The vicissitude of Japanese corporate law needs to be observed not only from a legal perspective, but also considering the economic and political contexts in which it took place. It is generally believed that the increasing frequency of amendments to the Commercial Code (especially the Company Part) was a response to the challenges of the economic depression in the 1990s. But the prolonged economic malaise complicated the task: it made it difficult to evaluate the efficacy and the correctness of these amendments, both on their face and in their substance. In light of this, a thorough examination of the changes of Japanese corporate law since the 1990s must be studied along with the broad economic changes that occurred during this period. Only then can the overhaul of corporate law, the creation of Companies Act, and their meanings be understood. To some extent, it will also help to estimate what changes the Companies Act of 2005 could bring to Japanese corporate governance in the future.

A. Economic Bubble in the 1990s

From the end of World War II till the 1980s, Japan in many respects had delivered tangible signs of success: rapid economic growth, a rising standard of living, booming

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25 For a more detailed discussion concerning this point, see infra II, 4, D, and E.
26 For a more detailed discussion concerning the push and pull for new organizational design in Japanese case, see infra III, 4 and IV, 3.
exports, technological leadership, and financial power. Japan performed well across a board range of social indicators, with high educational achievement, excellent health standards, low crime rates and little income inequality. By the 1980s, even modest Japanese had developed a certain confidence and pride in their economic system.  

This unprecedented economic success did not frizzle out quietly, however, but erupted in a moment of market euphoria in the late 1980s---now referred to simple as “the Bubble”---in which investors poured money into real estate and stock markets. When the Bubble finally burst in 1991, Japan descended into a prolonged economic slump that led to economic stagnation in the 1990s. The burst of the economic bubble in the 1990s presented a multi-dimensional challenge to Japan's economy, the second largest economy in the world at the time, and resulted in various changes. Challenges arose to the very institutions and culture that had been credited with Japan’s past success, such as powerful bureaucracy, close government-industry ties, lifetime employment, the main bank system and the dense inter-firm networks. After several futile attempts and lasting economic malaise, the range of reforms expanded beyond economic measures to those institutions standing behind the economy, such as industrial organizations, law, and government as well as the behavior and psychology of institutional actors.

B. The Change of Corporate Landscape

For the business world, the economic bubble in the 1990s and early 2000s provided a strong reason, as well as opportunity, to examine old business patterns, and in turn created pressure for a new mode of corporate thinking, behavior and governance structure.

From a broader view, several important changes in the economic landscape were contemplated and effectuated in this period, which in turn have had substantial impact on Japanese business circles and corporate law. Keiretsu (corporate conglomerate) started to dissolve. Corporate cross-holdings reduced substantially. Corporate reorganization became much more frequent and extensive. Companies tried to reduce their reliance on banks and shift from indirect finance to direct finance. Employment

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28 Id. For more discussion about the change of inter-company relationships, especially cross-holding, see infra IV, 3, B, a.
relations became less stable (large scale lay-off and life-term employment challenged), which caused much uncertainty among the general public. Shareholder activism and derivative suits emerged. The above features that were once generally considered to be fundamental in Japanese corporate governance were facing dramatic changes in the “lost decade” of economic stagnation. By the end of the 1990s, the Japan's economic picture had transformed, posing new questions about the validity of traditional understandings both in terms of law and society.

Among the observed changes, some possessed more fundamental power to affect the legal environment. The first development, and probably the most important one, is the weakening of the corporate conglomerate (Keiretsu) and the reduction in cross-holding among companies. In Japan, Keiretsu varies in forms from vertically integrating suppliers and distributors to horizontal industrial groups and constitutes dense and relatively stable business relationships. Horizontal Keiretsu helped companies provide preferential treatment to companies within the same group and, more importantly, promote cross-holding of each other’s shares. 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 takeover.

Another related change is the role of banks in corporate groups. Traditionally, the main banks played an important role in corporate groups in providing stable line of credit at favorable rates, monitoring group members’ performance and providing aid when necessary. That put main banks the center of the corporate groups and indirectly intensified the degree of cross-holding among group members. But since reforms in the mid-1990s, the Japanese government has been pushing for the reduction of corporate groups.


31 VOGEL, supra note 27, at 9, 126-34. Traditionally, the main-bank system is widely perceived as the central character of Japanese corporate governance. However, this point has been strongly challenged in more recent literature. See, e.g., Yoshiro Miwa & J. Mark Ramseyer, The Myth of the Main Bank: Japan
Second, against the wave of weakening authority of high-ranking corporate officers, shareholders started to gain their say in corporate affairs. Increasing shareholder activism and the idea of shareholder primacy have started to gain a foothold and present an increasing challenge to Japan's long-standing management system. But on the practical level, it rarely results in any substantial, or even actual, change in the distribution of power between management and shareholders. To the surprise of many observers, sometimes what has been happening may in fact be the opposite: management demands more legal authority claiming that they need it to deal with economic changes.

Third, another important aspect of the economic depression of the 1990s is its psychological impact. 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 life time employment and even massive layoffs in some industries, an unprecedented number of corporate failures, the growing disparity between rich and poor, etc.

However, all of these challenges to “business as usual,” and changes about the behavioral aspect of company, along with their corresponding amendments in Companies Act, have not brought the benefits expected. And this inevitably leads to a more central and fundamental set of questions for corporate governance: Who runs the company and should be responsible for the decisions about his company? By what mechanism can we choose the right persons 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 relocate themselves to one of the most unpredictable aspects of corporate governance: the governance organs.

4. Basic Rules of Japanese Corporate Governance Structure

Since the end of the World War II, Japanese corporate law has been keeping pace with American corporate law, possessing similar substantive rules in its basic structure. However, there are still several differences. This is especially true in terms of

governance structure. In this sense, it is necessary to start from a broader view of the whole governance structure in order to have a better understanding of the role and function of the independent director in Japan. It is noteworthy, however, that even after many amendments patterned after the U.S. model and the introduction in 2002 of the single board structure (Committee Structure Company), the basic German-Origin two-board structure remains a popular mode of corporate governance in Japan. Notably, the Japanese two-board structure is different from the original German version, and the two boards in Japanese Companies Act are parallel (see Chart 1), in contrast to the hierarchical relationship between the supervisory board and board of directors in Germany.

![Chart 1: Simplified Version of the Japanese Traditional Two-Board Company](chart)

A brief review of the Japanese governance rules follows.

A. Types of Companies
The types of companies in the Companies Act include general partnership company, limited partnership company, limited liability company and stock company. However, general partnership company, limited partnership company and limited liability company, as all collectively termed as “Membership Companies” or “Companies without Share” in Japan, are all considered to have a strong membership flavor and are under various restrictions such as unlimited personal responsibility and limitation of investment transferability. Because those features mentioned, these three

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32 Companies Act, art. 2, para 1, no. 1.
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.

Further, as stipulated in the *Companies Act*, all stock companies are a “public company” if they allow at least one class of their shares to be freely transferred.\(^{33}\) For those companies whose stocks are traded in stock exchanges, they are termed a “publicly traded company.”

**B. Shareholders Meeting**

Basically, the power of the shareholder meeting in Japan depends on whether a stock company forms a board of directors. According to article 295 of *Companies Act*, the shareholder meeting will be responsible for the organization, operations and administration, and all other matters regarding the stock company if it does not form a board of director. On the contrary, when a stock company forms a board of directors, the shareholder meeting’s power will be dramatically limited to those items stipulated in the *Companies Act* and articles of incorporation. In other words, for companies not forming a board of directors, the shareholders meeting is empowered to decide any decision concerning the management of the company.\(^{34}\) But for companies forming a board of directors (that means it has to have at least three directors), the authority of the shareholders meeting is limited to statutory items stipulated in the *Companies Act* and articles of incorporation.\(^{35}\) In this case, the shareholder meeting generally does not possess the power to be involved in the general management of the company. In practice, as most companies of certain size opt for the latter, the shareholder meeting in Japan is the organ for board corporate decision-making at its best without extending its power to execution.\(^{36}\)

Via shareholders meetings, shareholders exert the right to vote on directors and corporate auditors, with the former having responsibility for daily management of the company.\(^{37}\) Other than election and termination of directors and corporate auditors, 

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\(^{33}\) *COMPANIES ACT*, art. 2, para 1, no. 5.

\(^{34}\) *COMPANIES ACT*, art. 295, para 1.

\(^{35}\) *COMPANIES ACT*, art. 295, para 2.

\(^{36}\) According to *Companies Act*, all public companies are required to form a board of directors. *COMPANIES ACT*, art. 327 para1, no. 1. In other words, 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 the its management power to board of directors.

\(^{37}\) *COMPANIES ACT*, art. 329 para1.
according to the *Companies Act of 2005*, attendees of the shareholders meeting also possess legal power to vote on amendments to the corporate charter, mergers, divisions, dissolution, distribution of dividends, merger of shares and to decide when conflict of interest between directors and shareholders occurs, such as the ratification of directorial compensation. As mentioned, at the shareholders meeting, the body is only authorized to decide matters provided for in the law or in the articles of incorporation if the company has formed a board of directors, which is the case for most large, publicly-traded companies. In other words, if a company has only one director and does not form a board of directors, the shareholders meeting can resolve on anything related to management of the company without limitation.

Furthermore, the items reserved for shareholders meeting’s resolution by law are not subject to change by amendment to the articles of incorporation.

Shareholders meetings are usually held annually. Special meetings may be called from time to time. The main purpose of the general meeting is to approve financial statements, dividends and the appointment of directors and corporate auditors. Shareholders are entitled to one vote per share. Cumulative voting can be demanded by any shareholders, and a majority approval is required. Voting proxy is permitted, as long as it is in writing and filed before for each meeting. Other than those items reserved to shareholder meeting, in general, the power to manage the corporation is allocated to the directors.

For a public company, the shareholders meeting and board of directors are mandatory organs. If companies limit all classes of shares freely transferred, they can choose to

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38 *Companies Act*, art. 466, 309, para 2, no. 11.
39 *Companies Act*, art. 783, 795, 804, and art. 309, para 2, no. 12.
40 *Companies Act*, art. 783, 784, 795, 796, 804, 805, and art. 309, para 2, no. 12.
41 *Companies Act*, art. 471, 309, para 2, no. 11.
42 *Companies Act*, art. 452, 453, 309, para 1.
43 *Companies Act*, art. 180, para 2, 309, para 2, no. 4.
44 *Companies Act*, art. 361, 309, para 1.
45 *Companies Act*, art. 295, para 3.
46 *Companies Act*, art. 296.
47 *Companies Act*, art. 438 para 1 and 2.
48 *Companies Act*, art. 454.
49 *Companies Act*, art. 308.
50 *Companies Act*, art. 342.
51 *Companies Act*, art. 310.
have only one or several directors without forming a board of directors. But for all companies that have a board of directors, under the Companies Act of 2005, they have to set up either of the following organs: (1) a corporate auditor/board of corporate auditors; or (2) a committee structure with executive officers. These organs have different rights and responsibilities of managing the company on behalf of the shareholders.

C. Director, Board of Directors and Representative Director

Generally, the company is managed by the directors acting together as a board of directors, and directors enjoy a term of two years, which the corporate charter can reduce. However, according to the law, companies can choose whether to form a board of directors or not if that company limits all its shares from being freely transferred. If a company chooses to form a board of directors, the minimum number of directors is three. If a company chooses not to form a board of directors, it needs to have at least one director to carry out business management and represent the company. Companies which choose not to form a board of directors can still have multiple directors, and in this case, each director would have the power to represent his company and carry out business individually. However, the company can choose to limit the power to represent by stipulating it in its charter and delegating representative power to certain directors (which are called representative directors). The remaining board members will be simply “directors”, and their power to represent the company is limited by charter.

The difference between directors and representative directors, as mentioned above, mainly rests on the power to act on behalf of the company and at the same time directly incur legal obligation to the company. Based on corporate theory, only the acts carried out by those natural persons who have the right to represent the corporation will be considered acts of the corporation (or other legal entity) and will be binding to the corporation directly. In this sense, although default rules in Japanese

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52 Companies Act, art. 326, and art. 331, para 4.
53 Companies Act, art. 327.
54 The exact words are “(Board of director is) responsible for deciding execution of business.” Companies Act, art. 362, para 2, no. 1.
55 Companies Act, art.332, para1.
56 See supra note 36 and pertaining text.
57 Companies Act, art.331, para4.
58 Companies Act, art.326 para1.
59 Companies Act, art.349, para1.
corporate law state that all directors have the power to represent the company (i.e., to make their acts directly incur legal obligation to the company represented), companies can opt out and limit this power of representation to representative directors.

Representative director is the product of a larger board. Generally, Japanese companies have a relatively large board, more than 10 directors in most cases. Therefore, a smaller group of directors is needed to increase the ability to make business decision efficiently. At the same time, it may be too dangerous and create too much uncertainty when the power to act on the behalf of the company is delegated to, say, twenty persons.

In practice, most companies form a board of directors first, then directors choose one or more representative directors by resolution, and representative directors have authority to act on behalf of the company. Each representative director can individually represent the company and, in practice as well in law, representative directors are responsible for the day-to-day business of the company. The remaining directors who are not representative directors will not be directly responsible for carrying out business and their duty is mostly restricted to monitoring. In short, representative directors in fact dominate the running of company business, and the other directors can be considered “junior” non-representative directors compared to the “senior” representative directors, but non-representative directors can still be delegated certain executive power by the representative directors or the board.

Basically, representative directors have the power to either carry out decisions made by the board of directors, or to make decisions on his or her own if there is no contrary decision by the board of directors. The board of directors selects representative directors among themselves, and monitors the execution of business conducted by the representative directors and other directors when they are delegated

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60 For example, Toyota Motor Corporation, the largest automobiles maker in Japan, had 28 directors on its board in 2007. Among the 28 directors, only 10 directors are representative directors. Canon Inc., a leading office machines and consumer electronics manufacturer in Japan, had 27 directors among which two are representative directors. For a complete director list for these two companies, See, http://www.toyota.co.jp/en/about_toyota/executives/index.html; http://www.canon.com/about/outline/directors.html; http://web.canon.jp/corp/executive.html

61 COMPANIES ACT, art.363, para1.

62 COMPANIES ACT, art.363, para2.

63 COMPANIES ACT, art.362, para2 (2).
the power to carry out certain business.\textsuperscript{64} The \textit{Companies Act} also requires representative directors to report to the board at least once every three months\textsuperscript{65} and excludes the power of representative directors from certain major transactions which may affect the whole company substantially such as the sale of an important asset or the appointment of important positions.\textsuperscript{66} In that sense, the board retains the power to deliberate and decide on those major transactions.

In addition, the company may impose regulations to limit representative director’s authority, but internal regulations limiting the power of the representative director are not effective against third parties acting in good faith.\textsuperscript{67}

When directors are in disagreement in a company without a board of directors, the disagreement is solved by vote.\textsuperscript{68} 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. At least a majority of the directors must be present to constitute a quorum.\textsuperscript{69}

The relationship between the director and the company is governed by the law relating to mandate.\textsuperscript{70} Directors have a duty to conduct the business of the company with the standard of care of a good manager.\textsuperscript{71} The standard is higher than that expected in one’s own business. 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.\textsuperscript{72} Generally, Japanese courts and scholars agree, mostly by expansive interpretation, that the duty to manage implies the concept of duty of care and the business judgment rule in American law (with some variance).\textsuperscript{73} Moreover, the duty to carry out business faithfully infers the duty of

\begin{itemize}
\item \textsuperscript{64} \textit{COMPANIES ACT}, art.362, para 2 (3).
\item \textsuperscript{65} \textit{COMPANIES ACT}, art.363, para 2.
\item \textsuperscript{66} \textit{COMPANIES ACT}, art.362, para 4.
\item \textsuperscript{67} \textit{COMPANIES ACT}, art.349, para 5.
\item \textsuperscript{68} \textit{COMPANIES ACT}, art. 348, para 2.
\item \textsuperscript{69} \textit{COMPANIES ACT}, art.369, para 1.
\item \textsuperscript{70} \textit{COMPANIES ACT}, art. 330.
\item \textsuperscript{71} \textit{MINPO (CIVIL CODE)}, art 644.
\item \textsuperscript{72} \textit{COMPANIES ACT}, art. 355.
\item \textsuperscript{73} In his authoritative corporate law textbook, Professor Egashira summaries a long list of opinions from different courts and concludes that the majority of judicial opinions recognize a broadened discretion in considering whether a breach of duty of care has occurred. \textsc{Kojiro Egashira},
\end{itemize}
loyalty in American law (both require directors to place the company’s interest above their own interests).

D. Corporate Auditor and Board of Corporate Auditors

The corporate auditor (Kansa-yaku) is a corporate intra-organization designed to secure the fair and appropriate execution of corporate affairs. A board of corporate auditors is mandatory for large companies unless that company is not public company.75

The most important function of the corporate auditor is to monitor the propriety of the company's business practices. Mainly that means, 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.76 The idea of the corporate auditor comes originally from Aufsichtsrat 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 Aufsichtsrat. In Japanese law, although having the power to monitor directors and business practices, the corporate auditor is parallel to the director and is elected by the shareholders as a director;77 while in German law the Aufsichtsrat has the power to appoint directors, and the composition of Aufsichtsrat is a mix of the representatives of shareholders and employees, which is generally known as the “co-determination” mechanism.78 This means that the Aufsichtsrat enjoys greater authority over directors than its counterpart in Japan. Due to the hierarchical relationship in German law and the parallel relationship in Japanese law, the Japanese corporate auditor play a more preventive, conservative and supplementary role in Japanese corporate law and in general perception.

KABUSHIKIKAISHA HO (LAW S OF STOCK CORPORATIONS) 428–430 (2008). But in terms of the range judicial review, Japanese courts seem to extend to matters outside the core content of judgment. KANDA, supra note 7, at 203.

74 Other English translations often used include “Statutory Auditor”, “Company Auditor” or “Auditor”.

75 COMPANIES ACT, art. 328, para 1.

76 See COMPANIES ACT, art. 381, para 1.

77 COMPANIES ACT, art. 329, para 1.

78 For a comprehensive introduction to German co-determination and dual-board mechanism, see Mark J. Roe, Codetermination and German Securities Markets; Katharina Pistor, Codetermination: A Sociopolitical Model with Governance Externalities, both in EMPLOYEES & CORPORATE GOVERNANCE (Margaret M. Blair & Mark J. Roe eds., 1999).
The corporate auditor is restricted to directors or employees of the same company (including its subsidiaries) in Japanese law.\textsuperscript{79} To ensure its independence, the term of the corporate auditor is four years and cannot be shortened by amending charter articles.\textsuperscript{80} When forming a board of corporate auditors, there must be at least three auditors and the majority of board members must be “outside corporate auditors”.\textsuperscript{81}

Not only its role, but also the range of the corporate auditor’s monitoring is the subject of fierce debates in Japan. In essence, the debate is about whether the range of corporate auditors’ monitoring is limited to the legality of decisions made by board of directors or other managers, or can reach to the propriety of those business decisions. This disagreement persists as both sides of this argument have shortcomings. If corporate auditors were allowed to conduct propriety monitoring, it would erode the principle that the chairman and 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.”\textsuperscript{82}

Other than the gray zone mentioned above, the range of monitoring by corporate auditors generally includes ordinary business conduct and accounting. Also, corporate

\textsuperscript{79} COMPANIES ACT, art. 335, papa. 2.
\textsuperscript{80} COMPANIES ACT, art. 336, para 1.
\textsuperscript{81} COMPANIES ACT, art. 335, para 3. By the definition in the Companies Act, article 2, no.16, to qualify as an outside auditor, he or she cannot be 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. This is a major difference in the definition of independent director in the United States and Japan and generally considered to be a result of the corporate group in Japan.
\textsuperscript{82} For a more detailed discussion, see infra III, 1 and 3, C, a.
auditors are obliged to make a monitoring report and share its contents at the annual shareholders meeting. Moreover, the corporate auditor is responsible for filing suit when he or she discovers that a director (especially a representative director) is violating the law or any article on incorporation. In addition, each corporate auditor, whether the company has formed a board of corporate auditor or not, can exercise its authority independently.

E. The Accounting Advisor (kaikei sanyo) and Accounting Auditor (kaikei kansa jin)
The accounting advisor is a voluntary organ that companies can choose to form. Its main function is to produce all financial statements together with the directors. The accounting advisor must be a certified public accountant, audit firm, or a certified public tax accountant or tax accountant company, and enjoy the same term as the directors (two years in principle). The accounting advisor is elected by shareholders meeting and enjoys the power to examine all accounting material and to extend this power to subsidiary companies when necessary. The accounting advisor bears the obligation to report any suspicious conduct to the corporate auditors, board of corporate auditors, or shareholders if companies do not have either corporate auditor or board of corporate auditors. The accounting advisor also bears the obligation to complete an “Accounting Advisor Report” and to attend the meeting of the directors when reviewing relevant financial statements. The accounting advisor also has to express his or her opinion in shareholders meetings when having a disagreement with the directors regarding the approval of financial statement. In short, though somewhat independent, the accounting advisor is considered to be an auxiliary organ to the directors to help the directors ensure better internal compliance in accounting affairs.

83 COMPANIES ACT, art. 381, para 1.
84 COMPANIES ACT, art. 383, para 1.
85 COMPANIES ACT, art. 374, para, 1& 6.
86 COMPANIES ACT, art. 333, para 1.
87 COMPANIES ACT, art. 334, para 1, 2.
88 COMPANIES ACT, art. 329, para 1; art.374 para3.
89 COMPANIES ACT, art. 375, para 1, 2.
90 COMPANIES ACT, art. 374, para 1.
91 COMPANIES ACT, art. 376.
92 COMPANIES ACT, art. 377.
93 According to COMPANIES ACT, art. 2, para 3, no. 4, the terms “Yakuin” (literally translated as “directorship”) encompasses the director, corporate auditor and joint accountant. Although they are elected by shareholders meeting, accounting auditors are not classified as part of the “directorship.”
The accounting auditor is a functionally similar organ but one that works in the opposite direction. For large companies (as well as the committee structure company) it is a mandatory organ. The purpose of the accounting auditor is to audit all financial statements or relevant reports (made by internal accountants or accounting advisors) and make a report of his own. In performing this duty, the accounting auditor also has the right to examine internal accounting books as well as those of that company’s subsidiaries, if necessary. The accounting auditor also has the same duty to make a report to corporate auditors when irregularities or illegalities are spotted and must report in the shareholders meeting when he or she has disagreements with the corporate auditors. Also, shareholders may request a presentation by the accounting auditor by resolution.

Qualification of accounting auditor is limited to certified public accountant and audit firm. The term of the accounting auditor is one year, and the shareholders retain the right to elect the accounting auditor at the shareholders meeting.

(For an extended version of the corporate organization diagram, see below)

94 COMPANIES ACT, art. 327, para, 5; art.328, para 1.
95 COMPANIES ACT, art. 327. art 396, para 1.
96 COMPANIES ACT, art. 396, para 2, 3, 4, 6.
97 COMPANIES ACT, art. 397, para 1, 3.
98 COMPANIES ACT, art. 398, para 1.
99 COMPANIES ACT, art. 398, para 2.
100 COMPANIES ACT, art. 337, para 1.
101 COMPANIES ACT, art. 329, para 1.
F. Other General Features

Despite the broad similarities between Japanese and U.S. corporate law, the actual practice of corporate law in Japan differs remarkably from U.S. practice. For instance, shareholders in Japan rarely seek judicial enforcement of fiduciary duties.\textsuperscript{102} The

\textsuperscript{102} 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, \textit{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, \textit{ECONOMIC ORGANIZATIONS AND CORPORATE GOVERNANCE IN JAPAN}, 9 (2004). But the numbers
independent director is another example. In the U.S., independent directors have played a prominent role in corporate governance for at least four decades. However, the same mechanism was not present until late 1980s and is still comparatively rare in Japan. Other differences frequently mentioned include less frequency of hostile takeovers and proxy fights. In addition, regulators are permissive and informal in their enforcement of Japanese securities laws, and public enforcement is mostly present in the form of criminal investigation. As a result, corporate attorneys in Japan number only in the hundreds, which seems paltry when compared to the hundreds of thousands practicing corporate law in the U.S. To summarize, conducting business in Japan does not rely on or generate much formal corporate law. In fact a premium is placed on avoiding the law.

The role of the board of directors in Japan, among those issues mentioned earlier, represents another key difference. The board of directors in Japan, theoretically, is not only a part of the monitoring unit but also a managing unit. In actuality, the board of directors in Japan does not monitor the CEO; rather the CEO monitors the board members. In this sense, most Japanese corporations maintain a very conservative attitude toward the independent director or any individual, non-management director at all. By the mid 1990s, it was even claimed that in Japan there is no such thing as an independent director. But this bureaucracy and CEO-centrism started to receive

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).


104 See Ronald J. Gilson, The Poison Pill in Japan: The Missing Infrastructure, 2004 COLUM. BUS. L. REV. 21(2004). This has been changing dramatically and an unprecedented boom of mergers and hostile takeovers was recently recorded. For more discussion, see infra IV, 3, B, d.

105 MILHAUPT & WEST, supra note 102 at 35. For more discussion about the interplay between private and public enforcement in Japan, see infra IV, 3, B, e.

106 Milhaupt, supra note 23, at 111.


108 Symposium, 1994 Corporate Law Symposium: Presentations and Panel Discussion, 63 U. CIN.
strong critiques after the economic bubble burst in the 1990s. As result of these critiques, board structure gradually has become a central issue in the series of corporate reforms since the 1990s. Not surprisingly, the independent director, as part of efforts to import American style corporate governance to respond to those critiques, began to have a presence in Japanese corporate world in this period.

III. INDEPENDENT DIRECTOR UNDER CURRENT REGIME

1. The Change in Monitoring Mechanism in Japan: From Traditional Corporate Auditors to Two-Track System

Observing the change in the design of the corporate monitoring mechanism in Japan's corporate legal history is an interesting starting point for understanding the interaction among legal transplants, transplanters, and their embedded environment. Before World War II, the corporate auditor had full power to monitor all aspects of the business conduct carried out by the directors. However, when the board of directors was introduced as part of the second generation of company law in 1950, the law changed the status of corporate auditors, and the corporate auditor was moved from its previous higher status in its original German form to a parallel organ to the board of directors. As the board of directors as a whole started to gain more power in corporate matters, the representative director became the one to actually carry out daily business activities and make important decisions. The board of directors became the mechanism to monitor the representative director. The power of the corporate auditor was largely limited to accounting affairs, especially auditing.109

However, this change of basic corporate power setting after World War II has caused several issues to arise. First, the monitoring function of the board of directors over the representative director is not working as expected due to the way it is composed, i.e., the representative director controls the nomination of the remaining directors. Second, the Securities Transaction Law after World War II started to require companies traded on the stock exchange to retain a certified public accountant or auditing company to verify its accounting books and financial statements.110 In this sense, the auditing function of the corporate auditor was arguably redundant when the company is traded in on the stock exchange.


See, KANDA, supra note 7, at 250.

Act No. 25 of 1948.
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 director’s conducts, including business conduct other than those related to auditing. It was done in a divided way: In the Special Measure Law (Special Measures Law Concerning Corporate Auditing), it first required all large companies to set up accounting auditors and to thereafter accommodate the authority of the corporate auditor. For those companies not qualified as large companies, the power of the corporate auditor was still limited to account auditing and did not include general business execution. In 1981, the law permitted companies to have multiple corporate auditors, and even allowed standing corporate auditors. These changes reflected the need to reinforce the role that corporate auditors play in terms of internal monitoring even in the era when the economy in Japan started to regain its strength in the 1970s and 1980s.

In 1993, the term of the corporate auditor was extended from two years to three years. In this amendment, large corporations were required to have at least three corporate auditors and at least one of them must be an outside corporate auditor. In the meantime, the board of corporate auditors was introduced in law, and part of the authority was transferred from the corporate auditor to the board of corporate auditors. In 2001, the term was extended again to four years, and for large corporations more than half of the corporate auditors were required to be outside corporate auditors.\footnote{For an introductory list to the change made to the corporate auditor and other corporate monitoring mechanisms in last twenty years, see KANDA, supra note 7, at 163. EGASHIRA, supra note 73, at 287.}

Observing these historical developments, it is obvious that the fate of the mechanism of corporate auditors had been dominated by two simple realities: the ever-increasing need for more intensive monitoring efficacy 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, if is functioning at all.

However, a deeper issue lying behind these proposed amendments is the uncertainty legislators have about how to strike the right balance among the organs of corporate governance. As commonly recognized, the monitoring provided by corporate auditors is to a large extent insufficient, but at the same time legislators also fear that a dramatic change of corporate power allocation will impair the very essence of Japan’s
economic development pattern: a group of highly professional, devoted managers, represented by a board of directors mostly composed of senior managers who monopolize (almost) all corporate power. Thus, the dilemma between “inadequate monitoring” and “excessive monitoring” leads to a series of often well-intentioned but not fruitful reforms of the corporate auditor mechanism as a monitoring mechanism in Japan.\textsuperscript{112}

In this sense, along with these \textit{Commercial Code} amendments that have focused on the corporate auditor mechanism, another line of voices emerged asserting a broader view on the overhaul of governance practice and board structure in Japan. For example, in 2000, the Tokyo Stock Exchange wrote to all listed companies and requested that they revise their corporate governance practices to take into account shareholder interests to a greater degree. In 2002, The Tokyo Stock Exchange established a permanent corporate governance committee to advise the Exchange and listed companies\textsuperscript{113}. In 2004, he 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.\textsuperscript{114}

Concurrently, in order to deal with the challenges presented by new economic circumstances, the 2002 Amendment to the \textit{Commercial Code}, introduced a new board structure----the one board company with committees (\textit{iinkai-setsuchi-kaisha}, “committee structure company” or “committee structure company” hereinafter). The committee structure company, as a design inherited by Companies Act 2005, basically follows the single board structure adopted by most corporations in the United States. In the move toward American-style corporate governance, at least in the beginning, many Japanese academics and legislators believed this new board structure would fundamentally change the dominance of the traditional two-tier board system in Japan.

\textsuperscript{112} This is not to say that there is no monitoring mechanism in Japanese companies. Instead, there is an effective and continuous monitoring mechanism among board members, or to put in another way, monitoring is mostly carried out within the board and mostly done in a hierarchical fashion by senior managers such as CEOs. However, whether this kind of monitoring can supplement monitoring in a traditional sense is still a question requiring to further examination. For discussion of how the concern of “inadequate monitoring” led to the new amendments in 2002, see infra III, 2, B.

\textsuperscript{113} More information about the Listed Company Corporate Governance Committee of Tokyo Stock Exchange, see \url{http://www.tse.or.jp/rules/cp/committee/index.html}.

\textsuperscript{114} \textsc{Tokyo Stock Exchange, Principles of Corporate Governance for Listed Companies}, English version available at \url{http://www.tse.or.jp/english/rules/cg/principles.pdf}. 
and, in turn, infuse new ideas and dynamics into the Japanese corporate environment, providing a chance to cure many of the old, flawed practices.

2. Two-Track System

A. Independent Director Plus Committee Structure Company: Introduction

a. Before 2002 Amendment
Beginning in the early 1990s, increasing attention has been paid to the composition of the core corporate organ (i.e., board of directors) and its structural design. The focus first rested on introducing the independent director and encouraging its adoption. Later it turned to considering a more extensive application, and the more active role, of the independent director in terms of substantial board restructuring. In this light, it is necessary to look first at the independent director mechanism to understand these changes as a whole.

Basically, the defining attribute of the independent director is the requirement that the director not to have any direct interest relationship with the company’s top executive officers or the company itself other than directorial compensation. In Japanese version of the definition of independent director, provided in Companies Act article 2 (15), independent director means a director:

(1). who is not an Executive Director (referring to a director of a Stock Company listed in any item of Article 363(1), and any other director who has executed operation of such Stock Company) 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.

Generally speaking, although there is deviation in application, what "independent director" means conceptually in Japan is very close to what it means in the United States since it is a borrowed legal concept. Similarly, what lies behind this concept is the belief that only when a director can make business decisions without undue influence from the executive officers will the decisions best reflect the interests of shareholders and will monitoring over management be neutral and sufficient.

b. 2002 Amendment: Committee Structure Company (iinkai-setsuchi-kaisha)
Along with the voices from academia, the public, the even other government agencies (like the Tokyo Stock Exchange) demanding a more responsive and sound governance structure, the Japanese Parliament started to move toward a new corporate governance structure and laid its eye on the independent director mechanism as the answer. On May 22, 2002, the Japanese parliament passed revisions to Japan’s Commercial Code. The revisions, effective April 1, 2003, included a number of changes affecting the operation of boards of directors in Japan, including the notable introduction of the committee structure company.

The 2002 Commercial Code Amendment (relevant rules are inherited by the Companies Act 2005) introduced the committee structure company in Japan. According to the legal definition in the Companies Act Article 2(12), a committee structure company means a stock company which has a nominating committee, an audit committee and a compensation committee. But beyond this simple definition it appears, in reality this new rule creates a board structure parallel to the traditional two-board system and allows companies to choose a single board structure by amending the articles of the corporate charter. In this new structure, company can form a single board composed of directors only if it does not have any corporate auditors or board of corporate auditors. Under the board, a company can choose to form committees as sub-organizations to perform different functions. Those opting for the new system must establish the following three committees: a nomination committee, an audit committee and a compensation committee, in which members are directors and are elected by the board of directors. In these three committees, there must be at least three members and a majority of the members of each of the three committees must be outside directors.

For companies adopting a committee structure, rather than the two year term for directors in traditional structure companies, directors serve a term of one year. The fact that directors are re-elected annually in shareholders meetings reflects the

115 Act No. 44 of 2002.
116 COMPANIES ACT, art. 2(12).
117 COMPANIES ACT, art. 326, para 2.
118 COMPANIES ACT, art. 327, para 4.
119 COMPANIES ACT, art. 400, para 2.
120 COMPANIES ACT, art. 400, para 1, 3.
121 COMPANIES ACT, art. 332, para 3.
assumption that the directors in those companies are under more frequent and direct scrutiny from shareholders.

Corresponding to the single tier board structure, the 2002 Amendment also introduced a new corporate organ—the executive officer (shikkou yaku). The executive officer is a mandated organ in the committee structure company and is elected by the board of directors and delegated with the power to carry out business and make daily business decisions. The executive officer may be either one person or several and, like the directors, enjoys a one-year term. Although it may to a certain extent be contradictory to the spirit of distinguishing “monitoring” and “execution” in the committee structure company, it is permitted for a director to also be an executive officer in this single board structure, similar to the general practice in the United States, which allows CEOs or other high-ranking officers to participate in the decision making process as directors.

This amendment allows the boards of large companies, those most likely to be recipients of foreign investment, to operate using a single tier structure like boards of directors in the U.S. Whether to adopt a single-tier board or maintain their traditional Japanese style structure is up to the individual company’s discretion. The role of each committee is similar to the role that the committee would serve in a U.S. company. One interesting observation is that legislators did not show any preference for either of these board structures, and no supplementary measure to encourage Japanese companies to move from the traditional structure to single tire structure was found in this amendment.

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122 Companies Act, art. 402, 418-422.
123 Companies Act, art. 402, para 7.
B. Legislative Intent for the Committee Structure Company

There are two main reasons why the U.S. style Committee Structure Company was introduced to Japanese corporate law: the desire for a better monitoring mechanism and the hope to allow more flexibility for companies to pursue their business strategy. This section describes these two forces for change in more detail.

a. Breaking Management Centrism and Enhancing Monitoring

One useful source of information is the legislative material of the 2002 Amendment. In the explanatory submission and congressional testimony along with the Amendment 2002 of Commercial Code bill (for the House of Representatives), the
Ministry of Justice detailed the reasons for creating the Committee Structure Company. Basically, the most important reason to create this amendment is to help build a better separation between monitoring and execution functions in large companies. In the past, most Japanese companies did not maintain a clear distinction between execution and monitoring. Both directors and corporate auditors were promoted from managers and life-time employment had created a close group feeling which resisted outside opinion. In this sense, the monitoring function is less appreciated and insufficient. To cure this situation, three committees were created for companies in which outside directors were taking up the majority position and representing a group of actors who are independent from management’s influence. This could substantially increase the monitoring of the board of directors by creating a better separation between executive authority and monitoring. Among others, the Auditing Committee, with the support of its own staff, was in particular expected to bring a more effective monitoring mechanism to the executive branch of companies, and thus led to an effective control and elimination of corporate misconduct.

At the same time, by delegating the power to carry out business to executive officers, the committee structure company can help to create a centralized management chain, which in turn helps companies conduct business more quickly and respond to changes in the global economy more efficiently.

b. Reinvigorate Business by Lessening Restrictions and Providing More Organizational Choices

Second, the reason for the creation of the Committee Structure Company can be also observed in the series of Commercial Code amendments since the 1990s. An important theme commonly shared by the amendments since the 1990s was de-regulation. The wish to help companies regain energy had been a major part of legislative reasoning since the 1990s. This wish became strong especially in the midst of economic depression. According to this line of thinking, a more diverse, flexible legal environment would provide indispensable help to restore the vitality of corporations and would also help people conduct business in a more efficient way. As outlined earlier, these amendments shared a common feature: lessening the restrictions of the Commercial Code and empowering companies to choose the management structure they considered appropriate. In the explanatory submission of

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the 2002 Amendment, Justice Minister Moriyama also made it clear that the new organizational form was aimed at “meet[ing] the diverse needs of running a business” and “making the management process more reasonable.” In addition, he also stated that the growing speed of globalization of business and its management, including the tendency of listing of Japanese companies in the U.S. or European stock exchanges, made the relaxation of organizational form necessary to meet the need of international competition. In this view, the point of creating the Committee Structure Company was to recognize the needs of different companies and provide a more flexible legal environment in which companies can more easily adopt their own business and organizational strategy.

Furthermore, in the legislative discussion of the 2002 Amendment, it was easy to find that one of the most mentioned points is the voluntary feature of the Committee Structure Company. There was consensus among the Ministry of Justice, two diets of Congress and academics in the process of reviewing amendment proposals that a voluntary approach for introducing the Committee Structure Company served the goal of this legislation, which was to provide more options. The voluntary approach also clearly reflected the doubts about this design among business circles, legislators and even academics and the potential for strong resistance if the new structure was implemented universally and mandatorily. Voluntary adoption thus became the common ground, and congress settled with the Ministry of Justice’s version despite some noise.

Based on the views expressed in legislative discussions, the basic idea of the Committee Structure Company is to distinguish the power to make business decisions from the power to monitor the propriety of these decisions. In the Committee Structure Company, the core function of the board of directors is to monitor executive officers, while maintaining the power to make fundamental decisions like mergers, acquisitions or substantial asset deposition, and delegate the power to make general business decisions and their execution to executive officers. In this sense, a more clear

125 Id.

126 Opposing opinion in the course of the congressional discussion, mostly from the Communist Party, argued that the 2002 Amendment did not fix the insufficient monitoring problem of the current corporate auditor mechanism since the voluntary approach was not enough to provide a satisfactory motivation for change. Also they voiced that the Amendment 2002 did not put enough stress on the issue of increasing disclosure and strengthening shareholder derivative suits, which are even more fundamental to a better monitoring mechanism, *id* (especially the opinions of Congressman Matsushima Midori and Kijima Hideo).
distinction between “monitoring” and “execution” is set up, and executive officers are responsible to the board of directors and are required to report periodically to the board of directors regarding administration of the business. 127

The main purpose of this new rule is to enhance the transparency of the operation of the board of directors, increase monitoring and in turn reinforce the effectiveness of monitoring and avoid misconducts. By adding more independent directors to the board and reassuring their authority over management, the 2002 Amendment tries to break the traditional mode of corporate governance in Japan in which senior managers (or representative directors) dominate. Additionally, this amendment also anticipates bringing in more independent, objective opinions by having more non-employee directors on the board, and thus to avoid a narrow viewpoint which could endanger company performance as a whole, especially in the current fast-changing global economy. As a whole, the introduction of Committee Structure Company was anticipated to trigger a “competition among different designs” that could effectively lead to a productive competition with the traditional corporate auditor mechanism and eventually lead to overall enhancement of monitoring. 128

However, beyond the purpose discussed above, there seems a deeper, implicit reason beneath this amendment, namely to reshape the power structure in Japanese traditional corporate governance. Traditionally, in Japan, the representative director maintains the power to nominate both directors and corporate auditors, and at the same time control all corporate offices and resources through a chain of command. Directors and corporate auditors are promoted from the lower positions in the corporate hierarchy and are mostly life-time employees in the same company (or at least belong to the same corporate group). This practice effectively restricts the efficacy of the monitoring function that corporate auditors are expected to perform. The situation worsens when a majority of the directors are also concurrent employees (e.g., high ranking officers---they mostly are still under the representative officer, which is supposedly the highest business decision maker in practice), and thus unlikely to bring different voices to the table. Therefore, both the nomination process and corporate hierarchy effectively weaken the monitoring function originally invested to the directors/corporate auditors. In light of this, the key purpose behind introducing a new board structure composed of more independent directors is to break the representative director’s dominance over the board of directors and allow the independent directors to play a more important role in corporate decisions. As a result,

127 COMPANIES ACT, art. 417, para 4.
128 See EGASHIRA, supra note 73, at 284.
the tilt in favor of management in Japanese corporate practice may be somewhat corrected and the concept of shareholder supremacy could be, in turn, reestablished.

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

A. **Applicability**

Although the introduction of the committee structure company was to a large extent combined with the anticipation of having more independent directors on the board to ease the sole dominance of representative directors over the board, the independent director is a separate mechanism in concept. In fact, the concept of the independent director (and independent corporate auditor) was introduced in Japan earlier than the committee structure both in law and in practice. 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 who had already adopted independent directors voluntarily.\(^{129}\) Although the introduction of the committee structure company is considered to be an endorsement and a boost to a more extensive application of independent directors in Japan, the mechanism of the independent director and the independent corporate auditor in fact can be utilized in either the committee structure company or the traditional two-board structure company. But independent directors, due to the differences between the two structures, do not function in the same way in these two structures.

B. **Similarities**

In terms of function, the corporate auditor, independent director, and committee board structure all serve a similar need in terms of organizational design: to provide more effective monitoring over management in the absence of adequate direct monitoring by shareholders. However, even while sharing the same goal, different organizational designs bring different effects and may perform better in certain situations. A more careful examination of the differences of these organizational designs is therefore needed.

C. Differences

a. The Range of Monitoring

Before the advent of the committee structure company, the range of corporate auditors’ monitoring authority was a fiercely debated issue within the corporate legal academia. Traditionally, scholars have been divided into two camps on this issue. Some considered the corporate auditors’ monitoring to be limited to the legality of the decision of the board of directors: that means 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. They cannot, however, interfere when a decision seems merely suboptimal, unwise, or inappropriate. Following this interpretation, the responsibility and right to correct unsophisticated decisions belong to the board, since the real decision maker is the representative director.

However, another school of scholars believes that the range of monitoring 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 the issue of propriety since the job of the corporate auditors is to monitor the execution of business, which is carried out by the whole board of directors. In this sense, it would be not very meaningful to divide the range of monitoring into two sections. Surely the board of directors can and should monitor the representative director, however, this does not mean that they should be immune from the monitoring of the corporate auditor or that the monitoring of corporate auditors should take a different form.

From the viewpoint of either school, the committee structure company solves the issue since 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.

b. Voluntary Adoption v. Mandatory Ratio

In the traditional two-board structure, although it remains possible to allow the independent director to work within its framework, the reality is that it may not function as expected due to the large size of the board and more complicated division of labor under traditional Japanese practice. Nonetheless, it is obvious that the traditional two-board system can freely coexist with the independent director

130 See KANDA supra note 7, at 217 n.1. EGASHIRA, supra note 73, at 478 n.3.
131 EGASHIRA, supra note 73, at 506-07, 524-16.
mechanism under the current rule of Japanese law, and companies can adopt whatever number of independent directors they wish.

On the contrary, it is mandatory to have a certain number of independent directors in the committee structure company, and the number of independent directors must be able to constitute a majority on the nomination, auditing and compensation committees. This rule makes the relationship between independent directors and the committee structure company tightly tied, which produces both positive and unexpected negative effects.

c. Tipping Point
As mentioned above, the independent director, in theory, can be implemented in either the dual board structure or single board structure. Despite the fact that the adoption of the independent director is not limited to the committee structure company, the adoption of the single board plus committee structure is generally considered to provide a boost to the use of the independent director. The reason for expecting a larger presence of independent director on the board is that the key to a functioning independent director mechanism is to have at least a certain number, if not a majority, of board members who are independent. Only when independent members make up a significant portion of the board will they represent a balancing power to management and provide adequate monitoring power to prevent possible corporate misconduct.

In this sense, the key test of a successful adoption of the independent director mechanism is whether uninterested 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 in the committee structure company reflects the essential purpose of having independent directors on the board. Therefore, the committee structure company provides a better environment for the independent directors to perform its function successfully in comparison to the traditional two-tier board structure, even though the latter does not exclude the possibility for independent directors to join the board and exert their influence over it.

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132 COMPANIES ACT, art. 400, para 3.

133 Some might argue that if the independent directors are poorly picked by the nomination committee, and they lack real independence, the design difference between the traditional insider board and the new committee structure company is eliminated. However, the structural difference still makes the interference from CEO less easy, despite the risk of such misuse may substantially undermine the new design’s expected function.
D. Old Rules Reincarnated in Audit Committee

First of all, it is noteworthy that the audit committee in Japanese company law, although intended to mimic the American system, is in fact closer to the previous corporate auditor than the audit committee in the United States. By introducing the committee structure, Japanese legislators strangely crafted the rules about audit committee 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. 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.\textsuperscript{134} Another example is when the director unintentionally, 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.\textsuperscript{135} In another example, both members of the audit committee and the corporate auditors have the same right to convene a shareholder meeting when needed and both of them can bring a bill to the shareholders meeting for discussion. In light of this, the audit committee in Japan can be understood as an “integrated-into-one-board” version of the traditional corporate auditors system but not a real copy of the American-style audit committee.

The similarity between rules and functions of the audit committee and corporate auditors in Japan makes the committee structure in fact a deviation from the U. S. model that it intended to mimic. On the one hand, this phenomenon clearly indicates the difficulty involved in transiting 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 transition spoils the comparative advantage a competing mechanism is thought to offer and may completely destroy the intended result of a legal transplant.\textsuperscript{136}

\textsuperscript{134} \textit{COMPANIES ACT}, art. 405-408. \textit{See also} KANDA, supra note 7, at 218.

\textsuperscript{135} \textit{COMPANIES ACT}, art. 425, para 3.

\textsuperscript{136} One 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 forms of conflict such as shareholder suits. Many of the old rules about corporate auditors are kept for this reason. However, the same story can be told in a quite different way. Traditionally there is only a relatively weak shareholders suit mechanism in Japan. But since the 2002 Amendment and the new \textit{Companies Act} did


In a broad sense, the importation of a U.S.-style board structure did not entail fierce debate or much disagreement. Though some minor disagreements remained among different groups of actors, generally speaking the direction was agreed on in most government, academia, and business circles.

A. Business Associations and Lobby Groups

From the business side, some industry associations and political parties represent both the advocates and opponents of reform, and this is the reason that they do not push for the all-out victory of one side but rather arrange careful compromises between the two, i.e., the final result of voluntary adoption of committee structure in the 2002 Amendment. In reality, the divergence of interests between advocates and opponents of reform is not large as imagined, but is mostly about degree and method of implementing this new board design. For example, the Japan Chamber of Commerce and Industry, which represents small business, insisted that Japan should not emulate the U.S. model. 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. The Japan Business Federation (Nippon Keidanren), the most powerful industry federation and the largest business lobby in Japan representing competitive rather than protected not dramatically change the rules about the current shareholder suit mechanism, the void between the weak shareholder suit mechanism and the committee structure hence was filled by duplicating rules concerning corporate auditors, instead of changing the shareholder suit rules directly. Regardless of which version is more plausible, the fact is that many rules about corporate auditors remained in 2002 Amendment.

137 VOGEL, supra note 27, at 56-57.

138 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 http://www.keidanren.or.jp/japanese/profile/pro001.html/
sectors, advocated liberal, albeit more moderate than expected, reform and supported bringing in a U.S.-style board structure to increase companies’ options.\textsuperscript{139}

B. Company Level

Meanwhile, large corporations began to show an interest in various reforms in corporate law because they hoped that certain reforms would help them cope with the economic downturn through measures such as supporting share price, selling assets, reorganizing operations, or otherwise reducing cost. At the same time, they also feared the same reforms would make it harder for them to pursue long-term strategies and 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 toward reform.\textsuperscript{140} Beyond these positions, corporations’ stances on reform varied considerably depending on the philosophy of top managers.

C. Government 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 Ministry of Justice’s Legislative Council (housei shingikai), an advisory body dominated by prominent scholars, also started to work intensively on overhaul of Japanese corporate law beginning in the mid-1990s in response to the increasing calls for corporate law reform. The Commercial Code was amended frequently from the mid-1990s, and the two lines of reforms can be summarized as follows: one is to provide less restrictive legal environment for encouraging corporations to combat economic downturn, and the other is to enhance monitoring to stop corporate mismanagement.\textsuperscript{141}

The Ministry of Economy, Trade and Industry (METI) and Ministry of Justice (MOJ) both support reform on corporate law in principle, and MOJ officials saw the reform of Commercial Code as part of a larger effort---including industrial revitalization and

\textsuperscript{139} VOGEL, supra note 27, at 137.

\textsuperscript{140} Steven Vogel provides an in-depth discussion of eight case studies of how corporate restructuring proceeds on the individual company level. See VOGEL, supra note 27, at 164-96.

\textsuperscript{141} See Milhaupt supra note 23, at 98.
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 U.S.-style governance system while preserving Japan’s more “rational” (meaning less costly) legal framework. MOJ officials’ position was that Japan did not have powerful shareholder activists or class action suits to force changes in corporate governance---and did not need them---but it did need to enhance the existing system, by strengthening the mechanism of corporate auditors, for example.

In the process of deliberating the 2002 Amendment, Keidanren successfully lobbied against a proposal that would have required all to appoint at least one outside director. However, as the current definition of outside director allowed 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 traditional corporate group structure. Also, because of the lack of effective judicial review, and the expansive definition of the outside director, the new committee-system boards could actually reinforce “stakeholder tunneling” and managerial governance.

5. Implementation and Domestic Reactions

A. Committee Structure
Right after the passage of the 2002 Commercial Code Amendment which allows the creation of American-style board committees, several companies in Japan quickly announced plans to reorganize their boards. 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

142 According to an interview with an associate senior counselor, at the Civil Affair Bureau, Ministry of Justice. VOGEL, supra note 27, at 92.

143 See, id. at 94.


(especially those of the United States) when they were cross-listing. One important example is Sony Corporation.146

a. Survey in 2005
However, this trend seems to be short lived. In a 2005 study conducted by the Japanese Association of Corporate Directors, based on filing material and other public information, there were 67 publicly traded companies who adopted the committee structure by September 1, 2005. However, one interesting point is that among the 67 companies, 44 of them adopted this transformation in 2003, 13 companies adopted in 2004, and 10 adopted in 2005, which represents a clear tendency of gradual reduction of number of companies shifting from traditional two-board structure to new one-board structure.147 Observed from the listed markets, 49 of the 67 companies are listed on Tokyo Stock Exchange Section 1 (for large companies, which contained 1667 companies at the end of 2005) and 7 are listed on Tokyo Stock Exchange Section 2 (for mid-sized companies, which contained 506 companies at the end of 2005).148 Others are listed in 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 by and large corresponded to the total numbers of listed companies in different markets, and showed no clear evidence that company size mattered in the decision about whether to shift to the committee structure or not. Another point requiring more attention is that,

146 Upon transforming to the committee structure, as of July 2006, Sony Corporation has 14 directors among which three are representative corporate executive officers who head the corporation and are responsible for carrying out daily business decisions. At the same time, 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. Under the board of directors, seven leading officers constitute the executive group and 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 http://www.sony.net/SonyInfo/IR/governance.html, http://www.sony.net/SonyInfo/CorporateInfo/executive/index.html. For a discussion and comparison of the Sony’s governance standard and New York Stock Exchange’s corporate governance standards, see http://www.sony.net/SonyInfo/IR/NYSEGovernance.html.
148 For statistics about the number of all listed companies in 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 July 18, 2009).
among the 67 companies, the Hitachi group takes up 19 positions (roughly 28 percents) at that time. If excluding these two groups, the real number of companies that have shifted to the committee structure would be much smaller than it appeared.

b. Survey in 2009
In another survey conducted by Japanese Corporate Auditor Association in April 2009, 112 companies, including 39 non-publicly traded companies, had adopting the committee structure. Considering the total number of companies in Japan, the number is surprisingly lower than what was expected.

<table>
<thead>
<tr>
<th>Year</th>
<th>Publicly Traded Company</th>
<th>Non-Publicly Traded Company</th>
<th>Total</th>
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<td>5</td>
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<tr>
<td>2008</td>
<td>4</td>
<td>1</td>
<td>5</td>
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<tr>
<td>2009 (as of April 10, 2009)</td>
<td>1</td>
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<td>1</td>
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<tr>
<td>Total</td>
<td>73</td>
<td>39</td>
<td>112</td>
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Table 1: Number of Companies Adopt Committee Structure by Year

Source: Japan Corporate Auditors Association, 2009/4/10

(Note 1: Above figures are excluding 20 companies which re-changed back to traditional structure between 2003 and 2009)

(Note 2: Among 73 public traded companies adopting committee structure by April 10, 2009, 54 are listed on Tokyo Stock Exchange First Section, 4 listed on Tokyo Stock Exchange Second Section, 15 listed on other markets or stock exchanges)

c. Supplementary Observations
There are several points revealed in these surveys that require further attention.

First is about the low adoption rate of the committee structure. By March 31, 2009, Tokyo Stock Exchange First Section contains 1718 companies. However, only 54 of them have adopted committee structure, which is only slightly above 3%. The ratio of

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Tokyo Stock Exchange Second Section goes down to less than 1% (4 out of 457). In total, almost seven years after the 2002 amendment, only 2.3% of all TSE-listed companies have adopted committee structure. The remaining 97.7% of the companies still use corporate auditors.\footnote{Tokyo Stock Exchange, \textit{White paper of Corporate Governance} 2009, 15 (2009), \textit{available at} \url{http://www.tse.or.jp/rules/cg/white-paper/white-paper09.pdf} (last visited on July 18, 2009). In addition, the committee structure adoption rate dropped to 2.3%, down from 2.5% in the last survey conducted in 2006.}

Second, two corporate groups account for a large percentage committee structure adoption: Hitachi Electronics and Nomura Securities. These two groups take up about 28 percent of all companies adopting committee structure in Japan.

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<thead>
<tr>
<th></th>
<th>All</th>
<th>Hitachi Group</th>
<th>Nomura Group</th>
<th>All (excluding Hitachi and Nomura)</th>
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<tr>
<td>Total</td>
<td>112</td>
<td>17</td>
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<td>81</td>
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\textit{Table 2: Number of Companies Adopt Committee Structure by Year in Contrast to Two Major Corporate Groups Who Actively Adopt New structure (Source: Japanese Corporate Auditors Association, 2009/4/10)}

B. Independent Directors

The surveys mentioned above, however, are limited to the companies adopting the committee structure after the 2002 amendment of the \textit{Commercial Code}. As mentioned, companies in Japan still can have independent directors on their board without opting for the committee structure, despite the fact that these two designs are supposed to work hand in hand and the main reason for introducing the committee structure company in Japan was to encourage more extensive use of the independent director mechanism. 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. Number of Companies Having Independent Directors on the Board and the Number of Independent Directors on Tokyo Stock Exchange
--- | --- | --- | --- | --- | ---  
Companies Having Independent Directors (In Numbers) | 404 | 261 | 388 | |  
Companies Having Independent Directors (Percentage) | | | | 42.3% | 45.4%  

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

**Source:**
Tokyo Stock Exchange, White paper of Corporate Governance 2009.\(^{151}\)
Tokyo Stock Exchange, White paper of Corporate Governance 2007.\(^{152}\)
Tokyo Stock Exchange, Survey Result on Corporate Governance Matters of 2003.\(^{153}\)
Tokyo Stock Exchange, Survey Result on Corporate Governance Matters of 2000.\(^{154}\)
Tokyo Stock Exchange, Survey Result on Corporate Governance Matters of 1998.\(^{155}\)

Basically speaking, data in 1998, 2000 and 2003 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, survey covered all listed companies and participation is mandatory. Also, data in 2006 and 2008 are presented in percentage without absolute numbers of companies with independent directors; the results in 1998, 2000, and 2002 are presented in number but not percentage. The same is for the data in Table 5-1 and 5-2.

In a broad picture, by the end of 2008, about 45 percent of companies listed on the Tokyo Stock Exchange had independent directors on the board. In fact, the number has been growing from about 20 percent in 2000 and 30 percent in 2002. It clearly represents a trend of steady growth.

\(^{151}\) *Id.*, at 18.
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<td></td>
<td>8.99</td>
<td>8.68</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Table 5-1: Average Number of Directors (all TSE-listed companies)*

*Source:*

Tokyo Stock Exchange, White paper of Corporate Governance 2009.\(^{156}\)

Tokyo Stock Exchange, White paper of Corporate Governance 2007.\(^{157}\)

Tokyo Stock Exchange, Survey Result on Corporate Governance Matters of 2003.\(^{158}\)

<table>
<thead>
<tr>
<th>Percentage of Companies Having One Independent Director, in All Companies Which Have at Least One Independent Director</th>
<th>1998</th>
<th>2000</th>
<th>2002</th>
<th>2006</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>43.6</td>
<td>48.3</td>
<td>52.3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Percentage of Companies Having Two Independent Director, in All Companies Which Have at Least One Independent Director</th>
<th>1998</th>
<th>2000</th>
<th>2002</th>
<th>2006</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>26.7</td>
<td>28</td>
<td>25.8</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.81</td>
<td>0.86</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Average Number Of Independent Directors in All Companies Which Have at Least One Independent Director</th>
<th>1998</th>
<th>2000</th>
<th>2002</th>
<th>2006</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.91</td>
<td>1.90</td>
</tr>
</tbody>
</table>

*Table 5-2: Average Number of Independent Directors*

*Source:*

Tokyo Stock Exchange, White paper of Corporate Governance 2009.\(^{159}\)

Tokyo Stock Exchange, White paper of Corporate Governance 2007.\(^{160}\)

\(^{156}\) Tokyo Stock Exchange, *supra* note 150, at 18.


\(^{159}\) Tokyo Stock Exchange, *supra* note 150, at 18.

From Table 5-1, it can be clearly concluded that the size of board of directors has been substantially decreasing in the past decade. Although the average number of independent directors for those companies having independent director on board is staying roughly the same (slightly below 2) in this period, the dwindling size of board gives independent directors have more say on the board.

<table>
<thead>
<tr>
<th>Companies Type</th>
<th>Committee Structure</th>
<th>Non Committee Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Person(s)/ Year</td>
<td>2006</td>
<td>2008</td>
</tr>
<tr>
<td>0</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>1</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>2</td>
<td>6.8%</td>
<td>3.6%</td>
</tr>
<tr>
<td>3</td>
<td>35.6%</td>
<td>38.2%</td>
</tr>
<tr>
<td>4</td>
<td>25.4%</td>
<td>20.0%</td>
</tr>
<tr>
<td>5</td>
<td>11.9%</td>
<td>20.0%</td>
</tr>
<tr>
<td>6</td>
<td>3.4%</td>
<td>5.5%</td>
</tr>
<tr>
<td>7</td>
<td>10.2%</td>
<td>5.5%</td>
</tr>
<tr>
<td>8 and up</td>
<td>6.8%</td>
<td>7.3%</td>
</tr>
<tr>
<td>Average</td>
<td>4.37 person(s)</td>
<td>4.47 person(s)</td>
</tr>
</tbody>
</table>

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

Source:
Tokyo Stock Exchange, White paper of Corporate Governance 2009.164

<table>
<thead>
<tr>
<th>Companies Type</th>
<th>Non Committee Structure</th>
<th>Committee Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attributes/Years</td>
<td>2006</td>
<td>2008</td>
</tr>
<tr>
<td>Person who retired from unaffiliated</td>
<td>84.3%</td>
<td>92.4%</td>
</tr>
</tbody>
</table>

162 Tokyo Stock Exchange, supra note 154, at 3.
163 Tokyo Stock Exchange, supra note 155, at 3.
164 Tokyo Stock Exchange, supra note 150, at 18-19.
<table>
<thead>
<tr>
<th>Companies Type</th>
<th>Non Committee Structure</th>
<th>Committee Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attributes/Years</td>
<td>2006</td>
<td>2008</td>
</tr>
<tr>
<td>From parent company</td>
<td>12.7%</td>
<td>10.2%</td>
</tr>
<tr>
<td>From affiliate companies</td>
<td>14.1%</td>
<td>12.7%</td>
</tr>
<tr>
<td>Is a Major shareholder</td>
<td>20.6%</td>
<td>16.1%</td>
</tr>
<tr>
<td>Also an Independent director of other company</td>
<td>42.2%</td>
<td>45.7%</td>
</tr>
<tr>
<td>Also an executive officers/directors of other company</td>
<td>45.3%</td>
<td>46.0%</td>
</tr>
<tr>
<td>Relative of executive officers/directors</td>
<td>2.3%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Receiving compensation as an officer from the parent of the company or a subsidiary of the parent</td>
<td>8.2%</td>
<td>5.7%</td>
</tr>
</tbody>
</table>

Table 7-2: Relationship Between the Independent Director and His/her Company in the TSE-Listed Companies

Source:
Tokyo Stock Exchange, White paper of Corporate Governance 2009.166

All of the above data provides insights into how the independent director is implemented in Japan. From the outset, the independent director seems to establish a strong presence in corporate Japan, despite the unexpected low adoption rate of the
committee structure company. However, this difference may not be as accurate as it appears to be at first glance.

As mentioned earlier, under the current custom in Japan, simply having one or two independent directors on the board generally does not produce much substantial difference because the CEO still has more influence over the other members of the board. In this sense, having a real “functioning” independent director mechanism in a company and opting for a committee structure may relate to each other significantly. This stands in theory as well since the latter provides more institutionalized assistance for the independent directors to execute their roles as a monitoring mechanism and allows more power in matters such as director nomination, compensation and audit.

But another argument can be made here. Although according to the 2002 amendment, only two independent directors are needed to form a committee structure company, there may be reasons that keep companies that already having two or more independent directors from opting 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 would inevitably invite resistance. Second, choosing the committee structure means abolishing auditors or the board of auditors. But the interesting fact is that not every auditor can qualify as an independent director in the new structure since many of them have been employees in the same company for a long time and may not meet the criterion of independence required of independent directors. Even if some of the current auditors do meet the criterion of independence, this restructuring would lead to reallocations of corporate power among board members and auditors, which may not be something that the board and CEO want to deal with. Based on those factors, removing all auditors does not seem to be a practical option for many Japanese companies since it would incur much uncertainty and potential conflict. These two possible reasons may explain why only few companies have chosen to shift to a committee structure in Japan.

C. Academics’ Reaction
The academic opinion of the independent director mechanism in Japan is mixed. In general, many scholars agree that the introduction of the committee structure and independent director will help enhance the capacity of monitoring and bring several
One concern about the independent director in Japan is its effectiveness. As many academics indicated, the independent director itself cannot guarantee more effective monitoring. First of all, some commentators challenge the expertise of the independent directors and their knowledge of specific industries or firms. They also express doubt 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. Another concern is whether there are enough qualified persons who are willing to serve as independent directors to fill the huge demand that will arise if most companies in Japan move to the new structure. In contrast, corporate auditors in Japan, who mostly are promoted from the hierarchy of the company command chain, seem to be more advantageous due to their knowledge of the firm, and the fact that they generally spend more time in the company. These competitive advantages possessed by corporate auditors correspond to what is lacking in independent directors, and the same features in fact do make corporate auditors more capable of discovering potential misconduct. Further, in terms of interest alignment, corporate auditors, most of whom are insiders or former insiders, tend to have more financial alignment with the company and this alignment in turn will possibly make them more committed to high quality monitoring. On the contrary, the

167 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).

168 E.g., HIDEYUKI KOBAYASHI ET AL., SHINKAISHAHOU TO KOPORETO GABANASU (NEW COMPANY ACTS AND CORPORATE GOVERNANCE), 35 (2005).

169 E.g., NAKAMURA, supra note 167 at 17.

170 KOBAYASHI ET AL., supra note 168 at 36.

interest alignment with the company is less obvious or less important in the case of independent directors, and this will in turn make the monitoring of independent directors less motivated and even weak. Commentators also occasionally express their uncertainty about whether the independent director can really be independent in Japanese corporate environment and perform their monitoring role.

The second group of concerns rest mostly on the issue of how to reconcile the independent director mechanism with the original corporate auditors system, which continues to exist as an institution. For many academics, this concern is two-fold. The first issue is to decide who has the better ability to detect corporate misconduct, and the second is, assuming independent directors plus committee structure is superior in terms of monitoring, how to successfully move in this direction. In fact, for most companies, the most difficult part in implementing the independent director mechanism in Japan is to reconcile it with traditional corporate auditors, or to put it in a different way, to remove the corporate auditor and then implement the independent director. Conceptually, both the corporate auditor and independent director are designed to tackle the issue of monitoring potential managerial misconduct and are at least functionally interchangeable. But in Japan, the corporate auditor is a long existing mechanism with a strong hold in its environment. For example, corporate auditors in Japan formed a cross-industry Corporate Auditor Association, which has been lobbying actively and has considerable influence. The long existence of the corporate auditor makes replacing it with any other mechanism a difficult task. But the interesting thing is, despite its long history and extensive influence, the corporate auditor does not receive high recognition from academics due to the fact that it has not been functioning up to expectation. Therefore, there are forces both supporting

172 NAKAMURA, supra note 167 at 17.
173 KOBAYASHI ET AL, supra note 168 at 45. But similar a concern about whether or how to adequately perform the monitoring role also arises for the corporate auditor. See NAKAMURA, supra note 167 at 38, 46.

174 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. And this is indeed the reason for an on-going process of reform of the Japanese corporate auditors system for years. For a general discussion, see, e.g., Kazuhiro Takei, 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 SHOJII HOUMU (COMMERCIAL LAW REVIEW) 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.
and resisting the continued existence of the corporate auditor in Japan. And the result of the 2002 Amendment, which adopted the two-track system, seems to signal a victory for reformists, at least temporarily. But the situation has changed since 2003, when the economy in Japan started to recover. Momentum again has started to shift back toward the corporate auditor and the traditional governance model and hence leads to a more conservative attitude toward new governance structure.

IV. ANALYSES

I. What is the Problem that the Independent Director Aims to Solve in Japan?

Understanding of what the independent director in Japan means to its environment and the changes it brings about cannot be achieved through simply observing the way it is implemented. As a legal design with a specific goal, in order to evaluate how the independent director mechanism is faring in Japan, we must take into consideration both its aims and how much progress has been toward these aims.

The language of “enhancing monitoring within companies” in both the draft by the Ministry of Justice and congressional deliberation, allows several possible interpretations of the problem that the independent director mechanism is meant to address. Therefore, it is necessary to ascertain which exact issue is the intended target of this mechanism before further discussion can be conducted.

The main corporate governance problem in Japan, judging by the concerns expressed both in Congress and the press, is the manager/shareholder agency problem, but not the controlling/non-controlling shareholder agency problem. In introducing the independent director mechanism, the controlling-non-controlling shareholder agency problem had not been the focus of discussion. As generally perceived, most Japanese wealth is controlled by legal persons, i.e. by companies.\footnote{Tokyo Stock Exchange, Corporate Governance Whitepaper of 2009, 10 (citing most controlling shareholders in Japan are legal entities but not wealthy individuals).} Private wealth held by persons and families is also less concentrated in Japan than in a country like the U.S. This can be observed by the number of billionaires and their distribution in different countries. For example, according to Forbes.com, in 2007 there are 891 billionaires in

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the world, among which 21 are Hong Kong citizens, 36 are Indian, and 415 are U.S. American. Surprisingly, only 24 are Japanese. The highest ranked Japanese is No. 129, Masayoshi Son, founder of an internet company that controls a major portion of Yahoo! Japan, worth 5.8 billion.\textsuperscript{176} Compared to the U.S., there are not as many super wealthy people who privately have a large share of a company making them a controlling shareholder. This surprisingly low figure in Japan, the second largest economy in the world, reflects the reality of the relatively low number of individual holdings. Even when an individual owns a certain portion of shares, his or her power is still weak compared to the shares controlled by other companies, especially those with complicated ties to affiliates.\textsuperscript{177}

This phenomenon is often cited as corporate group or cross-holding. In this sense, controlling/non-controlling shareholder agency problem in Japan is somewhat unique. In its reality, Japanese companies are even closer to the Berle/Means model in which managerial control over companies pervades, but through a multi-layer structure with dispersed ownership structure. This means wealth is controlled by professional managers, who are again only agents without a direct financial stake. Therefore, those managers tend not to act like traditional controlling shareholders who would extract interest from non-controlling shareholders. The reason is that this may jeopardize their reputation as faithful agents even if the target is not the shareholders of their own company but those of their affiliates. When principals are remote and are mostly controlled by another group of agents like they are in Japan, agent mentality helps ease the problem of the controlling shareholder. The abuse of its controlling power is thus controlled by managerial professionalism and its distance to final financial interest. To say the least, the problem of the controlling shareholder in Japan, even when it happens, is among companies but not from wealthy individuals. This control


\textsuperscript{177} In fact, this phenomenon is partly due to historical factors. One of the most important is World War II and the occupation of the U.S. military that followed. Before the war, Zaibatsu (conglomerate owned by a wealthy family) was the main corporate form in Japan. However, after World War II, both the Japanese government and U.S. military considered Zaibatsu to be an unstable vehicle for further economic development in Japan and collaborated on eliminating them. After that, traditionally wealthy families became weaker and weaker, and a new concept of public companies owned by professional managers and employees started to emerge. \textit{See generally}, \textsc{Hirohiko Shimpo}, \textsc{Historical Development of Japanese Companies: Corporate Governance and Foreign Investment} (2009) (providing detail description about the rise and fall of Zaibatsu in Japan in the first half of 20\textsuperscript{th} century).
relationship is (at least in practice) less exploitative due to the limited, indirect financial interest agents in the controlling position can personally share.

But the question about whether these professional managers in a public company would act as the controlling shareholder and perform a checking function is another complex issue. In Japan, those who can exert controlling power over a company are in fact professional managers from other related companies that own a substantial stake in the company (mostly those who belong to the same corporate group). In the world of Japanese professional management, since the mutual lock-in is still strong and there is not much chance left for professional managers to easily change track and work for another company, due to cultural factors and the emphasis on knowledge about a specific company, their reputation for how they treat their parent companies, subsidiaries and other companies belonging to the same corporate group is important for garnering support from other managers, both higher and lower managers. This reputation (including a cooperative attitude toward senior managers and ability to be a team player) may help them later to move up to a higher position in the corporate hierarchy in the group. Especially when they all belong to the same corporate group with strong ties, it takes extreme courage to act in such a way that benefits one particular company but hurts the others at the same time. Hence, the excessive even exploitative use of controlling power as a controlling shareholder to extract financial benefit from affiliate companies does not benefit managers themselves much since they are evaluated both at the group level as well as the individual company level. Moreover, life-term professional managers do not have a strong incentive to boost performance in the short term to impress shareholders or increase his own value in a job market for high-rank managers, because the capital structure is relatively entrenched and transfer to other companies is not common.

Surly as professional managers, their reputation also matters when it comes to the responsibility toward their customers and employees. These factors altogether help prevent controlling/non-controlling shareholder agency problems in Japan. But by the same token, the strong inter-managerial control also leads to a governance pattern in which external monitoring is insufficient. This also explains why managerial centrism, i.e., shareholder/manager agency problem, is the major concern in Japanese corporate governance.

In terms of the creditor/shareholder agency problem, it is similar to the controlling/non-controlling shareholder situation in Japan. Historically, the most important financier has been the main bank at the center of the corporate group.
Although the role of the main bank has been weakening since the economic recession from the 1990s, the traditional role of main banks is still alive.\textsuperscript{178} For those companies belonging to a corporate group in which it has a main bank at the center, the main bank is often their major creditor and shareholder at the same time. As creditors also invest in equity, which is not uncommon in Japan, the conflict between shareholder and creditor is lessened as the two roles converge. Also, the main bank’s managers still face the same problem, such as professional reputation and inter-companies cooperation, as those managers who work in other companies. For these reasons, the creditor/shareholder agency problem is not a unique issue needing separate attention.

To sum up, how to control professional managers is the key issue in Japanese corporate governance. The three kinds of agency problem in fact all leads to the traditional shareholder/manager agency problem. As long as other safeguards, such as the responsibility managers feel toward investors and employees, are strong, the internal control from inside the group substantially controls the other two kinds of agency problems to a large extent.

2. \textit{Why So Few Companies Have Adopted the New Structure?}

As mentioned, the introduction of the independent director in Japan was interwoven with the concept of forming a new board structure, the committee structure. In the committee structure, the company sets up multiple sub-organizations under the board of directors, which are generally referred to as committees, and assigns certain functions to those committees. For committees occupying important task such director nomination, compensation and audit, independent directors must constitute a majority. The purpose of this arrangement is two-fold. First, in a sub-organization, a small group of people can work in a more intensive way, have specific skills, have a more responsive discussion, and focus on certain issues more efficiently. The other important facet of this organizational design is that, by appointing a portion of the directors to committees, the member composition of each committee can change correspondingly and distinguish it from the board. By appointing committee members with different attributes (such as financial expertise or all non-executive), individual issues can be more successfully addressed according to the designated function of each committee. For example, even if independent directors are only a minority on the

\textsuperscript{178} For a detailed discussion about the change of the role of main banks in Japan in recent years, \textit{see} VOGEL, \textit{supra} note 27 at 126-34.
board, appointing more independent directors to a committee can assure certain board functions delegated to a committee will be performed in a more independent manner.

Although there are several ways for companies to adopt the independent director mechanism under current Japanese law, it does not seem to be happening as the government expected. A question which naturally follows is: why have only a few Japanese companies adopted this new mechanism? To put it a different way, is there a market for the independent director? If not, why not?

A. The Non-Existing Competition over Governance Structures

Supposedly, different organizational designs, if they survive the test of the real world, would have different functions and in turn serve different needs for different people.\(^{179}\) Except in extreme situations in which one design is totally superior or inferior to all other comparable designs, each organizational design is supposed to have its comparative advantage over other designs under certain circumstances but not others, and that allows different companies to choose among designs according to the situations and their specific needs.

If this general understanding is true in terms of the independent director and corporate auditor in Japan, after observing the current implementation of the independent director mechanism, several questions can be asked: First, if in theory the design of the independent director with committee structure has merit in certain circumstances, what are those circumstances? Second, if as supposed there are certain circumstances in which the independent director mechanism has competitive advantages, why are so few companies adopting this mechanism? To put the second question in a different way, if different organizational designs really exhibit different competitiveness in different settings, why is there not a market for Japanese companies to compete with each other in terms of governance structure, which in theory could provide an increase in public confidence and eventually the attainment of cheaper capital?\(^{180}\)


\(^{180}\) This question is based on the proposition that the independent director mechanism has merit, at least for certain types of companies dealing with certain issues. For a more careful examination of the value of the independent director mechanism as an organizational design, see infra IV, 4, B.
The answer to these questions requires an understanding of how a market or a competition is formed. Generally, two elements are involved in the formation of a market. The first is to have enough people to join or participate in it (purchase or sell, i.e., a market is a collective phenomenon). The second is a difference between products so that consumers will be willing to make a choice. These two points may help explain why the independent director mechanism is not working in the expected way in Japan.

a. Discernible Differences
The first factor that explains why there is not a market for independent director in Japan is its uncertain positive effect as an organizational design. Not surprisingly, there is doubt over the “effect” of having independent directors in Japan, and this doubt has also spread to the potential for positive output of competing board structures. Even in the United States, starting from the mid 1990s, several empirical studies examined this question by showing the uncertain relationship between board composition and performance. Although those investigations are mostly limited to the United States, their results are in fact presenting a strong challenge for the rationales of the independent director.

Further, the output of better board composition and competition among governance structures rest mostly on the capital side, not the production side. If this is true, the value of the independent director will depend only on a capital market in which investors care about it and consider it important. Only then will better governance structures cause the acquisition of larger and cheaper capital. However, these conditions do not seem to clearly exist in Japan. To put it in a different way, if investors or creditors do not think independent directors make a difference or do not think they should care, they are not likely to make the first move.

b. Enough Number to Create Pressure
The second factor is the inertia of managers. For many Japanese companies, the cost and risk of introducing the independent director and committee structure is still unclear since there are only a few experimental examples since 2003. This scarcity of concrete success deters many companies from moving quickly into a new board structure, and it in turn creates a vicious cycle because when fewer attempt the switch, less knowledge about how to take advantage of this design accumulates. Therefore, hesitation gradually prevails and many companies that may be interested in the new structure may feel stuck since no one wants to move first without more knowledge on

\[^{181}\text{For more discussion about this point, see infra IV, 6.}\]
hand. Especially in the case of such a dramatic change in corporate structure like this, more information is desired in order for thorough deliberations to take place. In Japan, the need for a high degree of scrupulousness led to a collective hold-off. In short, this design was stuck in the early stage of a regular development process.

When there is no strong external pressure, managers tend to stick to what they are good at, and are not willing to give up what they. This inertia phenomenon has multiple dimensions.

First when most of the companies are managed by insiders who collectively have a taste for a certain type of competition, this taste, or ideology, will in turn decide the value of one particular set of skills. In Japan, having worked their way up from the bottom of the corporate hierarchy to top positions, most top managers were promoted according to their expertise in its industry. In this sense, their skills and understanding of this specific industry and company, as well as their loyalty to the company and a commonly-shared ideology with the other managers, are all important. This focus on industry-specific ability and its dominance reduce managers’ willingness and ability, collectively, to compete in other areas such as corporate structure. In other words, they may want to use their expertise to compete for the superior product or marketing strategy with other top managers in other companies. But they may not be as interested or confident in competing over finding optimal board structure, since designing an optimal board structure requires a different skill set such as a background in finance or law that they may not already have. This commonly shared view of values leads to a situation in which no one wants to compete in a field in which he or she feels less confident, and the result is that this “alternative” competition, and its potential benefits, may go unrecognized in the community.

Another explanation for this inertia is the threat outside experts pose to the authority of managers and the traditional system of corporate hierarchy. In Japan, traditional life-time employment has been helping to create a strong sense of territory among managers. Under this mentality, which has been re-enforced over time, managers do not want to step outside to contribute their loyalty to other companies, and at the same time they do not welcome other managers outside their companies to step in. In short, it is not easy for managers to allow someone from the outside to enter their small

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182 This explanation is similar to the long assertion of Masahiko Aoki. Aoki considers that Japanese corporate governance is linked to, and shaped by, its manufacturing techniques. For the discussion in this regard, see e.g., Masahiko Aoki, Toward an Economic Model of the Japanese Firm, 28 J. ECON. LIT. 1 (1990); Gilson & Milhaupt, supra note 144, at 345.
circle and give up the power that they have enjoyed for a long time. This is the general perception among most managers in Japan, and it forms a strong barrier to the introduction of outside professionals as independent directors.

It is as if managers in Japan are automatically forming a silent coalition---what they agree not to compete over is not a product, but a could-be better corporate structure.\textsuperscript{183}

\textsuperscript{183} One example to clearly illustrate the tension between existing values and the new entrepreneur is the case of the Livedoor event in the early 2000s.

Takafumi Horie was an internet entrepreneur in Japan who dropped out from University of Tokyo and found an internet company with 50,000 in 1995. Later he acquired Livedoor Company and started to use this name. Livedoor became an internet portal company that grew with a fast-moving acquisitive style. In the internet industry boom in early 2000s, Horie turned his start-up, Livedoor, into a household name and built it with aggressive moves unseen in Japan. Horie himself, born in 1972, became famous overnight for trying to wrest a baseball team from a league controlled by some of Japan's most powerful businesspeople, or, in his words, "the club of old men". In 2005, he caught the attention of the business world when he launched another hostile takeover bid for Nippon Broadcasting and its affiliate Fuji Television Networks, which is one the core companies of one of Japan's largest media groups. This bid later shocked all of Japan and caught international attention as well.

In this bid, several points are legally contentious. First, it was financed with an unusual type of convertible bond which gave its financier Lehman Brothers the right to convert the bonds into shares at a constant discount to the share price. This, in effect, would reduce the value of Livedoor's shares. Second, in this bid Livedoor and Horie acquired 35 percent of Nippon during after-hours trading. It turned out there was a loophole in Japanese law that did not cover after-hours purchases of large blocks and thus Livedoor was able to escape some regulations.

These contentious efforts from both sides later led to several litigations. This bid eventually failed, but the settlement between the two sides of this takeover bid brought Livedoor into alliance with Fuji Television Networks, which ended up a substantial shareholder in Livedoor.

Other than these successful and failed transactions, Horie himself has been the most un-Japanese of Japanese executives: a T-shirt-clad young Internet tycoon who became a national celebrity by breaking the rules and getting extremely rich along the way. To his opponents, his spiky-hair and trash-talking are the living challenge to Japan's establishment. But for his supporters, he is a great example of someone who has been able to break the rules and the dominance of the Japanese establishment by elite bureaucrats. Horie is often quoted, “All the evils come from aged business managers.”

However, in early 2006, Horie and Livedoor were caught under fire for several violations of the securities law and falsification of financial statements. Early 2006 Horie was arrested, and Livedoor (which was worth $6.1 billion before investigation came to light) dropped to one tenth of its earlier value. Horie was later sentenced to two and a half years in prison for fabricating 5 billion yen, or 42.5
With these mutual perceptions, managers restrict their range of competition automatically and believe others will do the same. This is similarly true for those who have retired.\(^\text{184}\) Therefore, if most of the companies are not on the move, the race has not even started and may never start in the future. Hence there will never be significant competition.\(^\text{185}\)

c. Before the Market Starts to Form

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million dollars, in earnings in 2007.

Horie's sentence triggers varying opinions. Horie’s supporters and some commentators (especially foreign newspapers) opined that the penalty is much more severe than for similar conduct of greater magnitude and the whole investigation was a conspiracy directed by a coalition of conservative, traditional managers. But others (especially Japanese newspapers) considered the sentence to represent a strong stand for corporate integrity led by the Japanese government. But undeniably, most people agree that the new “model” Horie represents is much different from the Japanese traditional way which encourages cooperation and mutual respect, and the traditional managerial centrism may not easily concede. For more discussion on the rise and fall of Livedoor and the tension between traditional and new business thinking, see, e.g., Floyd Norris & Martin Fackler, Rocking The Boat In Japan, N.Y. TIMES, Jan. 19, 2006, at C1; Norimitsu Onishi, A Renegade's Tale of His Scorn for Japan's 'Club of Old Men', N.Y. TIMES, Jan. 6, 2007, at A4; From Hero to Zero: Japan After Livedoor, ECONOMIST, Feb. 4, 2006, at 61-63; Saving Japan from the shadows: Saving it from the shadows; Japan after Livedoor, ECONOMIST, Feb. 4, 2006, at 10; Horie Disappoints Fans of The Unorthodox, THE NIKKEI WEEKLY (Japan), Jan. 23, 2006.

\(^\text{184}\) 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.

\(^\text{185}\) A study of the financial regulation/deregulation in Japan and early adaptation in economic recession shows a similar logic. In reviewing the interaction between depositors and banks when dealing with exceptionally low interest rates in times of recession, which led later to a zero interest rate, the study of the dynamic between banks and securities firms raises the question why depositors stick to major banks that provided overly low interest rates and did not switch to market-based financial instruments for a better return, even during the economic boom in the 1970s and 1980s. As the study concluded and is generally accepted, the main reason for prohibiting “competition of products” is to keep the balance between banks and securities firms. Moreover, the lobbying and pressure from banks also contribute to the unsaid policy of “balance” vis-à-vis “competition.” For a similar analysis, see also Frances McCall Rosenbluth, Financial Deregulation and Interest Intermediation, in POLITICAL DYNAMICS IN CONTEMPORARY JAPAN 111, 123-25 (Gary D. Allinson & Yasunori Sone ed., 1993).
The above discussion is an attempt trying to explain why there is not a market for the independent director and single board structure in Japan. If a market for governance structures emerges and starts to function, conceivably, most companies will try to find an optimal structure for itself and it will lead to a maximization of utility for all. However, this seems not to be the situation in Japan. Then, the inquiry continues thusly: what can be done to create a more dynamic market? If a market cannot be created unless the relevant parties are willing to trade, then the question turns out to be how to eliminate those factors that prevent competition if competition is considered good by the general public. In this light, the discussions will go into the analysis of the relevant factors, which affect the willingness to compete and the formation of a market.

3. The Dynamics

A. General Counter Factors: Cultural Factors (Team Work over Individualism and Intra-Company Authoritarianism); Governmental Bureaucracy; and Resistance from Established Institutions

The reasons why the business world in Japan seems resistant to the idea of the independent director and committee structure are multiple. The most noticeable include the uncertain benefit of the independent director and the transaction costs incurred in changing corporate structure. However, the size of these costs has not been clearly accounted in the Japanese corporate law literature. Therefore, it is still unclear to what extent the economic factor has an effect, or if it is simply used as an excuse.

In addition to the economic cost, the Japanese resistance to the independent director mechanism is also related to issues such as path dependence, mode of competition, and power sharing, which all have deep roots in Japanese history, politics, and culture. For example, Japanese culture values harmony and consensus. It has long been at ease with powerful and centralized institutions. They would account for the existence of large, concentrated, block-holding institutions like the keiretsu and the main banks discussed earlier or other government-led business coordination. Also, it would partly explain why Japan allows these large, centralized institutions to do most of the governance work.186

186 Milhaupt, supra note 23, at 115.
Other reasons include psychological aspects such as company loyalty and team mentality. The idea of life-time employment remains strong among high-ranking officers, and the preference for being part of group rather than working alone to a large extent contradicts the character of independence and the check/balance function that people in the independent director mechanism are expected to perform. In fact, what constitutes loyalty is the sense of belonging to a place or a group of people. In this sense, the conflict between “loyalty” and “independence” makes the choice to be an independent director like a game of “either-or,” but not a win-win situation since ideas about “independence” often work directly against cherished, centuries-old Japanese cultural traditions.

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 his or her field or profession. Surely the loyalty issue and professionalism may prevent people doing too many jobs at the same time. However, these issues can be solved in time or as the mentality changes. But the common perception that the independent directors do not adequately perform their monitoring functions makes qualified people less likely to want to become an independent director, since this stigma may put their professional reputation in risk.

B. General Supportive Factors: Dissolutions of Corporate Group, Cross-Listing and Accounting Reforms, Corporate Scandals, M&A Wave, and Liberalization of Employment Relationship

a. The Dissolution of Cross Holding Among Corporate Group

Due to Japan’s history and culture, Japanese corporate structure did not evolve according to the Berle and Means paradigm. In showing that corporate structure was path dependent, scholars have demonstrated that the Berle and Means paradigm does not apply to the Japanese case.\(^{187}\)

There may well be cultural and historical reasons for the slow pace of change in corporate governance. Corporations in Japan focus on the importance of consensus in decision-making. Relationship among people and companies therefore plays an extremely important role in the Japanese business world. Traditionally, the corporate group in Japan was built on complex, mostly preferential business relationships and

\(^{187}\) Gilson & Roe, supra note 30, at 875, 905.
cross-holdings among its group members. In this system, a main bank was the center of a corporate group, and it helped provide funds and liquidity to group members and coordinate business conduct.\textsuperscript{188} Due to cross shareholdings and \textit{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 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.\textsuperscript{189} Finally, the Japanese government also played an important role in corporate governance, and the government has shown a willingness to intervene to assist troubled companies.\textsuperscript{190} All of these factors together helped create a stable and closed circle of professional managers who controlled corporate Japan.

The economic recession in the 1990s, however, changed much of the traditional corporate landscape in Japan. One of the most important changes is the weakening of the corporate groups. Facing the changes that occurred in the 1990s---especially the bank crisis---main banks, if they survived the bubble, started to cease playing their role as capital providers to the previous extent because they had already taken on too many loans from group members, which in turn led to the irrational economic bubble and its burst.\textsuperscript{191} At the same time, more and more surviving firms formerly belonging to corporate groups became financially independent. They started to move toward disintermediation (shifting from lending to capital market financing) and internationalizing, or retaining their own profit to meet the need of capital in the future.\textsuperscript{192} Also, firms started to dump shares of other group members to stop losses as the price of shares of those group members dropped.\textsuperscript{193} This change attenuated the tie

\begin{footnotesize}
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\item 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, \textit{Changes and Crisis in the Japanese Banking Industry}, in \textit{INSTITUTIONAL AND TECHNOLOGICAL CHANGE IN JAPAN'S ECONOMY----PAST AND PRESENT} 120, 120 (Janet Hunter& Cornelia Storz eds., 2006).
\item \textsc{Vogel, supra} note 27, at 9, 130;
\item Allison Dabbs Garrett, \textit{supra} note 145, at 168 (2004).
\item For how the bad debts changed the Japanese financial system and the role of main-banks, see \textsc{Yoshikawa, supra} note 29, at 51-60.
\item \textsc{Vogel, supra} note 27, at 126. Gilson & Milhaupt, \textit{supra} note 144, at 351.
\item 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 value of company assets by forcing firms to report portfolio losses. \textsc{Vogel, supra} note 27, at 88-90.
\end{enumerate}
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among group members and accelerated gradually as different members exhibited different level of ability to survive in this new economic situation.

As a result, cross-holding has been reduced substantially since 1995. According to data from Nippon Life Insurance Research Institute (NLI), the cross-shareholding ratio of all Japanese listed companies (2674 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% in 1987 to 43.4% of 1995, then to 27.1% of 2002.\textsuperscript{194}

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% in 1987, to 10.09 of 2002, and to 8.65 of 2006).\textsuperscript{195}

Both of these changes have important effects on the capital structure, attitudes, mindsets, and business strategies in Japan. For example, when facing a certain proportion of outflowing shares, company managers need to take demands from shareholders about share price more seriously. Also, the ability to raise more funds from capital markets and the concern about the threat of potential hostile takeovers, in turn, all become eminent. In this sense, the weakening of the system of cross-holdings is gradually changing fundamental features of traditional Japanese corporate governance, and the deep impact of these changes became more obvious after the economy started to recover. However, the relationship between the changes to the cross-holding structure and to the management structure still requires further observation. Commentators argue that the \textit{Keiretsu} still exists though weakening, and


\textsuperscript{195} Keisuke Nitta, NLI Research Institute, \textit{Corporate Ownership Structure in Japan—Recent Trends and Their Impact}, 4 (2008). Available at \url{http://www.nli-research.co.jp/english/economics/2008/eco080331.pdf}. 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 reduction and the proportion of reduction are largely the same (about forty percent) and can be easily observed in both surveys.
the management system is still under the dominance of insiders. Also, the broad definition of independent director in Japan may well be used to facilitate the organization of corporate groups.

c. Change in Long-Term Employment Relationship and The Weakening Idea of “Life Time Employment”

Traditionally, Japan has been proud of its long-term employment guarantee. The long-term employment guarantee was considered as an important element in Japan's economic system, which along with the financial and political system complements the national system of economic governance.

But this time-honored practice had faced severe challenges since the economic recession of the 1990s. Prolonged stagnation and mounting pressure triggered several structural changes. From the figures of employment rates in this period, it is not difficult to grasp some sense of how long-term employment was affected.

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197 Gilson & Milhaupt, supra note 144, at 364-65.

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Table 8: Unemployment Rate in Japan
Source:
Japan Statistical Yearbook and Japan Institute for Labor Policy and Training

Generally, when dealing with economic recession and the pressure to cut costs, the first step companies tend to take is to mobilize employees to increase productivity, or transfer employees to other healthy branches. If those methods fail, then cutting wages and reducing working hours (or transforming employee status to low-cost “temporary” employees) will be the next options. If all of the above fail, managers would then consider layoffs and plant closures. Layoffs especially are generally believed to hurt the company’s image and impair its ability to recruit new employees in the future. 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 at a time when many companies were suffering from the economic recession.

In this atmosphere, the traditional corporate loyalty and long-term employment commitment started to gradually weaken and change. The increasing closure of businesses and rising unemployment triggered a feeling of insecurity among employees and a pressure on managers to do whatever they can to keep companies afloat. This in turn led to a more liberal attitude toward employment relationships among both employers and employees and a greater mobility.
Ironically, a new need accompanied the economic recession. Since the 1990s, the restructuring of business, along with the advent of new types of business such as the high-tech industry, telecommunications, and other new service sectors, required new types of work forces and created a new need for different types of skilled workers. However, this demand could not be met by replacing it with unemployed labor. This mismatch between labor market demands and surpluses was further emphasized by technological innovations. The change of industry, both in its structure and content and the insufficient labor demand in traditional industries due to stagnation increased labor market volatility.

This volatility then led to a change of mentality and softened the traditional idea about life-time employment and corporate loyalty. The weakening notion of life-time employment and the increasing mobility will not only provide more qualified personnel for the job of independent director, but will also help to shape a new sense of corporate loyalty, which is not to a CEO or a vague idea of “corporation,” but to investors and shareholders. This change indeed could help create a more friendly environment for the independent director in Japan

d. Accounting Reform After Major Corporate Scandals in 2001, and The SOX's Influence

In addition to the series of 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 U.S. 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 accountants in Japan. Stronger regulation of the accounting industry is also among the proposed reforms, and led to “Financial Instruments and Exchange Law” which contains many similar rules

203 YOSHIKAWA, supra note 29, at 144-46.
204 YOSHIKAWA, supra note 29, at 146-50.
contained in the Sarbanes-Oxley Act in the United States. In fact, the law has been dubbed the Japanese version of the Sarbanes-Oxley Act, hence J-SOX.  

As imagined, one important catalyst for these changes is the enactment of the Sarbanes-Oxley Act in the U.S. In fact, the influence of the Sarbanes-Oxley Act in Japanese corporate circles was two-fold. On the one hand, it triggers more domestic accounting reform proposals initiated by Japanese authorities. On the other hand, many Japanese companies who trade their securities (either directly traded on US stock Exchanges or in the form of American depositary receipts) are directly regulated by U.S. securities regulations including Sarbanes-Oxley Act, which requires higher auditor independence and that independent directors play a heavier role on the board. This approach also creates a greater tendency for a more extensive participation by independent directors in corporate management and decision making.

But as expected, problems with stricter accounting rules and reporting obligations are emerging. Especially for those companies who need to comply with U.S. securities regulations, companies are starting to raise concerns about the time and financial resources spent on rule compliance and to fear negative effects on both corporate earnings and future listings.

\[e. \] \textit{Two Major Factors May Change the Shape of Independent Director in Japan in the Future (I): Hostile Takeovers Wave}\n
In 2003, Japan's economy started to show signs of recovery from more than a decade’s recession. As a result, the business landscape started to be shaped by new dynamics. Some companies that survived the downturn of the 1990s started to recover and gain comparative advantage as a result of the experience of restructuring and adaptation. Many other companies were still suffering from low share price, even

\[206\] The Financial Instruments and Exchange Law 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 Law and a compilation of related materials, see Financial Services Agency, \textit{Financial Instruments and Exchange Act}, available at \url{http://www.fsa.go.jp/en/policy/fiel/index.html} (last visited July 23, 2009).

Meanwhile, people started to accept the idea that hostile merger and acquisition will help corporate assets to flow to more productive uses and increase economic efficiency. The series of amendments to the Commercial Code between 2000 to 2003 also encouraged corporate restructuring by permitting various means such as share buy-back, stock options (for shareholders as a poison pill), and issuance special class of shares with veto power in electing directors. These factors altogether have created a more favorable environment for takeovers. Indeed, 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 500 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 10-year period.

In general, takeovers in Japan were not welcome before this merger and acquisition wave. Though the reasons may be multiple and complicated, traditionally people in Japan tend to consider M&A neither a regular business activity for the business world as a whole nor a normal business strategy at the individual company level. This is especially true for hostile takeovers. However, circumstances had changed much since the turmoil in the 1990s. In the latest several years, takeovers have become much more common in Japan. Some cases even happened in the way that would hardly be conceived just some years ago. Among these changes, not only the broad environment

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208 In a survey of the market capitalization of 779 non-financial firms traded in Tokyo 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 23, at 108.

209 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, 2004 COLUM. BUS. L. REV. 67, 71-72 (2004).

and mentality, but the law itself has successfully evolved to reflect a more or less neutral, even welcoming, attitude toward hostile takeovers.\textsuperscript{211}

This change, in theory, provides a favorable environment for the use of the independent director in Japan. In fact, the rise of hostile takeovers forces many companies to consider and adopt varying defense measures, including US-style rights plans. This abrupt change echoes the growing threat of hostile takeovers, and in turn the advice from Delaware jurisprudence triggers greater use of the independent director as a balancing mechanism.\textsuperscript{212}

For example, in the shareholders meeting season of 2007, 222 companies aimed to introduce a takeover defense that can delay tender offers by requiring suitors to explain their prospective business plans, according to a survey conducted by Nikkei Inc. The firms account for 8% of all companies that close their books in March and hold general shareholders meetings in June.\textsuperscript{213} But at the same time, shareholder activists and proxy advisers also urge companies to have more independent directors on the board and allow committees comprised of independent directors to review the defense measure before it is proposed to the shareholders meeting.\textsuperscript{214}

\textsuperscript{211} 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 60% 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 takeover against another domestic company," with multiple answers allowed, 41.2% picked "There are cases where a hostile bid is unavoidable," and 30.6% answered that "Hostile bids should no longer be judged negatively." If an overlap in responses is taken into account, 61.2% showed a positive attitude toward hostile takeovers. \textit{Majority of Firms for Hostile Takeovers}, THE NIKKEI WEEKLY (JAPAN), Oct. 30, 2006. In another survey of the presidents and chairmen of major corporations, conducted in July and August 2006 by Nihon Keizai Shimbun Inc, a leading Japanese economic newspaper, 71.4% said they would consider M&As given an attractive proposal. Another 4.5% said they would enthusiastically consider an M&A plan if it were amicable, and 0.8% said they would weigh a hostile takeover if necessary. All told, 76.7% see M&As as a possible business strategy. \textit{Growth To Last Over Year: 42% of Execs}, THE NIKKEI WEEKLY (JAPAN), Aug. 14, 2006.

\textsuperscript{212} Cf. \textit{Outside Directors Taking on Watchdog Role}, THE NIKKEI WEEKLY (JAPAN) June 20, 2005.

\textsuperscript{213} \textit{Firms Seek Takeover Shield}, THE NIKKEI WEEKLY (JAPAN), July 18, 2007.

\textsuperscript{214} Id.
Debates about how to pursue a takeover strategy but more about how to defend companies from unwelcome takeover bids have taken center stage in discussions of Japanese corporate law literature. The amount of related discussion has been increasing rapidly particularly in the recent years. Japanese managers are struggling to make an unwilling choice between giving up part of its power to the outside directors and facing a bigger threat of losing all managerial power to hostile suitors. However, it is undeniable that the rise of hostile takeovers and its countermeasures have encouraged the implementation and use of independent director in Japanese corporate governance. Though how much actual change will result remains a question, and the trend warrants close and careful observation in the future.215

f. Two Major Factors May Change the Shape of Independent Director in Japan in the Future (II): Derivative Suits and Courts’ View?

215 It is noteworthy that the Ministry of Economy, Trade (METI) and the Ministry of Justice (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.) The Takeover Guidelines recommend a three-prong test for determining whether a takeover defense is reasonable, which 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 209, at 72-75 (2004). Cf. Curtis J. Milhaupt, Prescribing the Pill in Japan?: Foreword to the Hostile M&A Conference Issue, 2004 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, 2004 COLUM. BUS. L. REV. 21, 33-36 (2004).
When compared to how the independent director works in the United States, it is obvious to corporate law scholars and business actors that there is an important part of the mechanism which is missing in Japan: a comparable mechanism aggressively promoting corporate derivative suits such as the plaintiff bar in the U.S. Basically, derivative suits and the independent director mechanism are tightly connected and supplement each other in Delaware jurisprudence, where the independent director mechanism is used as to countervail aggressive derivative suits and the plaintiff bar. In short, it performs a balancing function between managers and shareholders.\textsuperscript{216}

Under the current regime, private derivative litigations and SEC investigations are two major forces that substantiate American corporate governance and are keys for curbing misconduct in the United States. In contrast, many other countries have comparable public enforcement but do not have a comparable counterpart in private enforcement. The lack of adequate private ordering through derivative suits is also obvious in Japan and has been criticized as a major fault.\textsuperscript{217}

However, public enforcement may risk a loss of flexibility in the form of uniform rules. Moreover, public enforcement sometimes may be carried out either too aggressively or too passively because of the politics involved. In this sense, when public enforcement is not sufficient, or when it sticks to the principle of internal affairs and faces a limited range of monitoring, private enforcement will then become important. As a central piece of private enforcement, derivative suits with help from the professional plaintiff bar may be more effective at monitoring especially when the internal control within firms is insufficient.

But derivative suits and the plaintiff bar do not come without a price. Some consider that an aggressive plaintiff bar may unduly interfere with management and in turn become detrimental to efficiency, or even in some extreme cases might be used as a means of extortion. For this reason, independent directors in the U.S. emerge to preserve managerial discretion, with conditions, but at the same time still allow room for shareholders to challenge those decisions. In short, it works as a safety valve to mitigate the potential misuse of shareholder derivative suit.

To prevent derivative suits from unduly interfering with management, as in the U.S., the independent director can work as a mechanism which allows court to use a more

\textsuperscript{216} See generally, Gordon, supra note 103, at 1523-28.

\textsuperscript{217} See generally, Mark. D. West, Why Shareholders Sue: The Evidence from Japan, 30 J. OF LEGAL STUD. 351 (2001).
procedural approach to solve corporate disputes without stepping into the core of business disputes in Japan. Here the independent director has in essence a double role. On the one hand, it conducts internal control as it monitors management. In this sense, it is itself part of private enforcement. On the other hand, it serves as a balancing force to prevent derivative suits brought with the help of the plaintiff bar from being too aggressive. This double use of the independent director is particularly meaningful in Japan, if moving toward a heavier reliance of private enforcement is expected.

The second part of this double role, however, depends on the courts’ deference to decisions made by independent directors. When dealing with corporate law cases, if courts express deference to judgments made by independent directors and hence apply less strict standards of review, it will give management a weapon in cases like extortion and in turn increase their willingness to have independent directors on the board. Currently, the rule of directorial liability in Japan (for both independent directors and other insider directors alike) is like a negligence rule.\(^{218}\) This situation becomes more difficult for directors due to the fact that corporate law in Japan is highly regulated and directors are more likely to be found liable in the name of violating the law or corporate charter, compared to situations directors face in the United States. The lack of deference to business decisions, including mistakes and risk inherent, prevents the independent director mechanism from taking better hold in Japan. It hence creates a vicious circle and makes courts less willing to defer to independent directors’ decisions. In this sense, a real independent board may help earn a more preferential treatment from the courts, break the circle, and in turn make shifting to the one-board system more appealing.

To sum up, from the standpoint of countries like Japan, there are many potential methods for promoting the derivative suit without over-encouraging it, in the sense of an implementation strategy. On the bright side, since the level of both public and private enforcement is relatively low and the voice for more effective means to curb corporate misconduct and increase monitoring capacity is steadily growing, the independent director mechanism indeed seems promising as a linchpin to encourage other mechanisms as well, compared to the current weak internal check in corporate Japan today.

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\(^{218}\) Basically, directors in Japan bear duties to manage the company with good care (“zen kan chuu giimu,” COMPANIES ACT, art. 330; CIVIL CODE, art. 644) and loyalty (“chuu jitsu giimu,” COMPANIES ACT, art. 355) which are similar to duty of care and duty of loyalty in U.S. law. For the latter, the general negligence standard applies. See, EGASHIRA, supra note 73, at 428.
4. **Back to Normative Approach**

In discussing the merit of the independent director mechanism, there are two questions that are closely related but need to be distinguished. Whether the independent director has any level of merit, and to what degree or under what circumstances, is an issue that should not be confused with whether the corporate auditor or independent director is a superior monitoring mechanism. The first question focuses more on the examination (both in theory and its implementation) of the independent director mechanism itself, and extends to whether it can trigger better performance. The second question focuses more on the comparative advantage that arises from a comparison among this and other mechanisms. This is to say, in theory, it is possible to obtain a positive answer to the second question and at the same time have a neutral answer to the first question. To be more specific, although these two questions are to a large extent related, in some countries it is still possible to infer a conclusion that independent director is a better monitoring mechanism even though it is still inconclusive whether the independent director by itself possesses any merit such as enhancing company performance.\(^{219}\)

A. **Problem Remains Unsolved**

Generally speaking, corporate auditors and independent directors, as different organizational designs aiming at the same goal, represent various degrees of design difference. For many critics in Japan, both the traditional structure and the new committee structure are all the same if the selection of independent directors and corporate auditors are both based on their loyalty to CEOs. For others, the organizational setting of independent directors and the one-board system may very likely help to reestablish the primacy of the board over the CEO and other managers, and in turn will lead to a better degree of monitoring over management as a whole.\(^{220}\)

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\(^{219}\) If this happens, it 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*, IV, 5.

\(^{220}\) In fact, the lack of sufficient 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 also the major reason why an alternative governance structure is 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 Shigeru Morimoto, Inkai Tou Secchi Kaisha Seido No Rinen*
However, while this disagreement remains, the basic issue is still left unresolved in the Japanese business world. Recognized as the core issue in Japanese corporate law since the 1970s, inadequate monitoring has been one of the main concerns of legislators as well as corporate law scholars in Japan. This is also the reason why the Japanese legislature brought a series of amendments focusing on reforms of the corporate auditors in the 1970s and then introduced the independent director and committee structure in the late 1990s and early 2000s. Therefore, the evaluation of the independent director mechanism in Japan cannot evade the basic question: how an adequate monitoring model can be produced and which method ---the independent director in the single board structure or corporate auditors in the traditional dual-board structure--- is superior. With this question examined, the comparative advantage of the independent director mechanism in Japan will be easier to demonstrate.

B. Better Monitoring and Structural Difference: The (Comparative) Merit of Independent Directors

There are two interesting points to observe regarding the main differences between independent director and corporate auditor as monitoring mechanisms. The first one is which mechanism demands its members to be truly independent or allows them to actually act independently, which is indispensable to effective monitoring. The second is whether combining the traditional two-board structure into one board is better or worse, and from what perspective.

The first difference is limited due to the difficulty in materializing “real independence” by legal demand. In fact, it is easy to find many “not-independent” directors who nonetheless meet the legal requirement to be “independent.” Further, the same difference can also be easily eliminated by having “real-independent” corporate auditors from the outside. In short, though independent or not is a decisive difference, clear independence is not something that can be easily achieved merely by

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 Committee and Corporate Auditors), No. 1666 Junkan Shoji Houmu (Commercial Law Review), 4 (2003); YUKIMI KAWAGUCHI, SHAGAI TORISHIMAYAKU TO KOPORETO GABANASU (OUTSIDE DIRECTOR AND CORPORATE GOVERNANCE), 175 (2004).

221 For a discussion on the legislative reasoning, see supra II, 4, A and C; for a discussion on earlier attempts to revamp corporate auditor mechanism, see supra I, 1 and 2.
conceiving a different organizational design; other factors such as liability rules or cultural reasons affect independence.222

However, the second difference is more important if one looks more closely. The dual board system in Japanese corporate law has quite distinct features from its German origin. In Japan, the board of corporate auditors is an organ parallel to the board of directors. Its function is supplementary and limited to a certain range (which varies as the debate of legality or propriety shows), and does not have the authority to elect directors, nor the power to relieve directors of duty.223 In practice, though parallel in appearance, the so-called “two-board system” in Japan is not two equally equipped boards, but a big, powerful board of directors with a small, weak board of corporate auditors. In this sense, a single board structure can more effectively monitor management by bringing all related people in 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 in two board structure to hierarchical, and hence expand the range of oversight by consolidating it and avoid the traditional confusion over the range of monitoring in the Japanese corporate literature. Further, if independent directors have a majority (or at least a substantial number) on the board, they can exert the power to elect and remove top managers and delegate managing power, which is considerably the most powerful weapon in terms of monitoring.224

222 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.

223 The power to relieve the duty of a director is reserved to the shareholders meeting in Japan. With the majority resolution, the shareholder meeting can demand the director resign even without just cause. See COMPANIES ACT, art.339, para1. If no majority resolution is reached, a 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.

224 Misao Tatsuta clearly pointed out that the important 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 (COMMERCIAL.
Under single board structure, independent directors would possess substantial comparative advantage over the traditional the two-board system in Japan. Even leaving aside the possibility of bringing in more outside professionals to enhance the capacity of monitoring, the hierarchical structure and the restoration of the right of appointment of the CEO and other high ranking officers will help to reestablish the authority of the board of directors over managers. It also helps solve the continuous disagreement of the range of oversight in Japanese corporate law literature, and hence lead to more effective monitoring.

On the contrary, a structure dividing authority between two boards weakens its authority to manage both, 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. Conversely, it is easier for them to recognize themselves as agents of a company but not agents of a CEO when the CEO has to report to seven or ten directors not twenty directors plus five other supervisors. The more people the management has to report to, the less the management tends to feel like it under direct control, and the intensity of authority relations hence becomes weaker. It is easy to understand that when the power is divided by more people each member will tend to be able to exert less authority. Furthermore, a bigger has higher the costs of intra-communication and will be less efficient. It therefore makes sense to both downsize and unite the bodies of monitoring.

Moreover, when it is established that the board has the unified and final authority to run a company, it will help the employees who are lower on the chain of command establish a concrete sense of agency (i.e., primacy of shareholders). Also a stronger sense of responsibility will be built up 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.

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 is especially true when both boards are targeted 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

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practice. In this sense, simplicity in structure will bring much benefit such as cost-efficiency and clarity to current corporate designs.

Based on the general comparison presented above, the comparative advantage of the independent director over the traditional corporate auditors system can hence be established. The basic idea underlying this assertion is as follows: (a) it is not prudent to expect someone to monitor himself or a group of people to monitor themselves in an effective way in the long term. In other words, if the distinction between the monitors and the monitored is obscure or when the monitors and the monitored share a strong common interest, it is less likely the monitoring will be effectively performed; (b) In terms of the committee structure and traditional corporate auditors system, even in the worst scenario when these institutions can only play similar functions in reality, it would make more sense to choose the one with the simpler structure since it costs less than maintaining a large and complicated organizational arrangement; (c) Furthermore, in the one-board structure, it is easier to identify who has the responsibility to monitor and whether they have done it in the right way. In contrast, in the Japanese corporate auditor model, the law states that the board of directors is responsible for monitoring the propriety and the corporate auditors are responsible for monitoring the legality of the representative director/CEO’s actions. This division is not only unpractical since the line between “inappropriate” and “illegal” is hard to draw both in theory and in reality, but it also weakens the capacity to conduct effective and timely monitoring by giving the same role to multiple players.

Judging by history, a structure dividing authority between two boards as observed in Japan results mostly in duplicity and redundancy. It does not help improve monitoring capacity in any obvious way. On the contrary, it not only weakens the authority of both boards 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 responsibility of agents. Once it is established that the board has the authority to run a company, truly effective monitoring will occur more easily.

5. **Reforming Corporate Auditors as an Alternative?**

Theoretically, changing the traditional auditors system and requiring independence for all corporate auditors may serve the purpose of proposing independent directors in the
Japanese context---enhancing monitoring. However, there are several facts concerning business practice that need to be recognized. First, most business actors, as well as the general public in Japan, do not consider their auditor system to be functioning well enough, if at all. This perception has long historical roots and cannot be changed by small adjustments. Even pushing in this direction will be at least as costly as introducing and implementing a new mechanism, like the independent director.

Leaving aside the issue of implementation and focusing on the enhancement of monitoring capacity only, whether the 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. However, the issues that people are more worried about in Japan, based on the discussion of draft legislation in Congress, are the monitoring and independence needed to find out if a company has suspicious interested transactions, reckless business decisions, intentional manipulation, or even fraud. In this sense, though it can be re-configured to work as a more independent body, whether the corporate auditor can function as a better monitoring mechanism than the independent director is still under doubt.

In fact, when forming a board of corporate auditors, half of the auditors are required to be chosen from outside the company by the Companies Act of Japan in 2005. Further, they have a mandatory four-year term which cannot be shortened by shareholder meeting in public companies. The purpose of both rules is to increase independence. Despite these safeguards, there are several fundamental flaws in the corporate auditor mechanism.

The first flaw in the corporate auditor mechanism is its nomination process. The current nomination of corporate auditors is initiated by the board of directors. In fact there is a different voice arguing that Japanese managers are under enough intra-company monitoring and do not need a further outside monitoring mechanism. NAKAMURA, supra note 167, 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 to tell them about that).

226 The board of directors in Japan has the general power to call a shareholder meeting and decide the agenda and motions to be voted. See COMPANIES ACT, 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. COMPANIES ACT, art. 343 para 1.
which is in turn controlled by a representative director or CEO. This process unavoidably compromises auditor independence. When the nomination of corporate auditors is controlled by the board of directors as currently designed, all assumption of independence becomes doubtful.

The second flaw is that corporate auditors in Japan do not have the right to remove managers or director directly. The power to remove high rank managers is reserved to the board of directors under current rules. Removing director can be done by a shareholder majority resolution, in most cases. But the power to file a motion in shareholder meeting, including removal of director, is generally controlled by the board of directors. In this sense, corporate auditors’ monitoring capacity is mostly indirect, and only when illegality is spotted can this power be exerted.

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 obscurity will bring up much uncertainty if corporate auditors push their monitoring capacity in an aggressive manner.

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227 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 shareholder meeting to deliberate and vote on. See COMPANIES ACT, art. 303 and 305.

228 COMPANIES ACT, art.362 para 2, no. 1and para 4, no. 4.

229 COMPANIES ACT, art. 339 para1.

230 See supra note 226. But a minority shareholder also has right to file a motion when certain criteria are met, see supra note 227. 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, art. 854.

231 One similar challenge is, under the setting of the traditional dual structure, both 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 168, at 38.
<table>
<thead>
<tr>
<th></th>
<th>Corporate Auditors</th>
<th>Independent Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nomination</td>
<td>Nominated by directors/board of directors</td>
<td>Nominating all directors, including independent directors</td>
</tr>
<tr>
<td>Choosing Top Managers</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Removing Top Managers</td>
<td>No</td>
<td>Yes (By resolution of the board of directors)</td>
</tr>
<tr>
<td></td>
<td>(But when illegal conduct by top managers is spotted, can request director or board of directors to do so or report it to the shareholder meeting)</td>
<td></td>
</tr>
<tr>
<td>Information Right</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Range of Monitoring</td>
<td>Limited. Focused mostly on accounting and generally not involving the propriety of business decisions if legal</td>
<td>Full. Mostly about major business decisions and choosing audit personnel</td>
</tr>
<tr>
<td>Time Spent in House</td>
<td>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)</td>
<td>Short, generally several hours to days a month</td>
</tr>
<tr>
<td>Power to Influence</td>
<td>In the corporate auditors system, the board of directors tends to be much larger than the corporate auditor or board of auditors. That leads to a general imbalance between the two boards</td>
<td>In an independent director system, boards tend to be smaller. So each independent director has bigger decision power (in terms of voting)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>Corporate Auditors</th>
<th>Independent Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring Cost</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Potential Opposition From</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Professional Managers</td>
<td></td>
<td>(Less high ranking positions)</td>
</tr>
<tr>
<td>Fit with Traditional Corporate Group</td>
<td>Slightly less</td>
<td>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)</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>--------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Simplification of Structures and Relevant Rules</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Will Require More External/Regulatory Checks?</td>
<td>No substantial difference</td>
<td>No substantial difference</td>
</tr>
</tbody>
</table>

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

6. **About Statistical Studies of the Relationship Between Independent Directors and Company Performance**

Traditionally, the independent director is considered to be an important mechanism for curbing managerial centrisim, increasing monitoring of managers and hence improving shareholder protection and performance in the United States. However, though it has been being evident feature of American corporate governance for more than three decades, the independent director mechanism’s ability to improve performance began to be questioned in the late-1990s. This debate constituted a serious challenge to the traditional understanding about the merit of independent director in the United States and triggered much important discussion.²³²

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From the outset, the challenge was posed by using statistics to examine the relationship between performance and board independence and see whether more independent directors leads to better company performance. Supported by statistical evidence, several studies, of companies in the United States, report an uncertain relationship between a higher number of outside directors and better company performance. In their studies in 1999 and 2002, Prof. Black and Bhagat conducted extensive empirical surveys on this issue and argued that the composition of the board and higher number of independent directors on the board do not mean better performance. As the studies show, the boards with supermajority of independent directors perform worse than those with other compositions, and boards with more inside than independent directors perform about as well as boards with majority (but not supermajority) independent boards.  

Whether or to what extent these studies debilitate the traditional reasoning is a subject demanding further scrutiny. First, not all statistical surveys agree with Black and Bhagat’s findings. For example, one earlier statistic research, aimed at the same topic and published in 1996, contradicts Black and Bhagat’s findings. This inconsistency in surveys indicates that the nature of the relationship between performance and board independence may not be definite, and the conclusion may well vary as the range and comprehensiveness of research change. Second, statistical studies themselves face several limitations. An obvious one is the difficulty in defining “independence” and how to measure it in absolute terms.

a. External Monitoring vs. Internal Monitoring

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234 Laura Lin, The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 NW. U. L. REV. 898, 922 (1996) (“Four studies have found some evidence indicating a positive relationship between the presence of outside directors and the financial performance of the firm”).
If Black & Bhagat are correct, the higher degree of monitoring would have no causal relationship with the existence of independent directors on the board. But before jumping to agree or disagree with Black & Bhagat’s assertion, it is worthwhile to look from the other end of spectrum, i.e., a world in which all monitoring comes from the inside. As traditional reasoning goes, first, it is important to have a good monitoring mechanism in place to deal with the agency problem. A better monitoring system will provide indispensable help to avoid self-dealing, waste, or other potential misconduct, and this preventive function will lead to a better output and hence better performance. Second, relying on the same agents to watch over themselves may not be a practical way to monitor. On the contrary, reducing distance between those watching and those being watched and allowing these two groups to build up strong ties may substantially jeopardize the monitoring function and compromise its effect. Adding these points together, the importance of maintaining an outside monitoring mechanism then becomes evident.

If the above reasoning holds, the next problem is how to understand the conclusion presented by Blank & Bhagat’s studies. Assuming a causal relationship can be established between a sound monitoring system and better performance, then a reasonable reading of Black and Bhagat’s findings may include either that (a) the independent director does not monitor at all. Instead, the use of independent director in the United States simply reflects a historical coincidence or a mistake by the U.S. courts to let firms use such mechanism to insulate themselves from extortionate but otherwise costly-to-defend self-dealing claims; or (b) an improvement in monitoring brought by independent directors is certain, but the benefit of better monitoring is offset by the cost of increasing the number of independent directors or the efficiency lost due to the distance between independent directors that must be crossed to attend to the details of corporate affairs; or (c) the enhancement of monitoring capacity does successfully lead to improvement of performance, but for some reason this improvement of performance did not appear on the scale used in Black & Bhagat’s studies.

For the first possibility, if the assertion is maintained and accepted that internal control alone is not enough in the long run and control from outsiders is hence necessary, then at least the validity of the first implication mentioned above must be

235 For more recent discussion of the importance of independence on boards, see, e.g., Note: Beyond "Independent" Directors: A Functional Approach to Board Independence, 119 HARV. L. REV. 1553 (2006). As for performance of board monitoring, see, e.g., Gordon, supra note 103 at 1515.
temporarily set aside until further theoretical explanation is discovered that can change the traditional notion about the distinction between “internal” and “external”. So the quest continues with possibility two and three.

b. Explanation 1: Trade-Off

Some commentators argue for the second explanation. For example, Professor Jill Fisch and Caroline Gentile pointed out that the independent director does not bring unqualified benefit. Independent directors, may lack disabling conflicts of interest, but may also lack sufficient focus and involvement regarding the affairs of the issuers they serve. In other words, this “off-set” theory points out that the independent director is a mix of advantages and disadvantages, and to some extent posits that the presence of independent directors on the board results in sacrificing “efficiency” or “focus” for “security.”

Though the explanation may survive the statistical surveys in terms of logic, there are other explanations for why the value of enhanced monitoring brought by independent directors is not reflected in the statistical literature.

c. Explanation 2: Spreading Effect

After more than fifty years’ of implementation of the independent director mechanism in the United States, a general understanding has been established that requires managers to recognize that shareholders are the ultimate owners of a company and all managers and employees work for the interest of the shareholders and subsequently are subject to internal or external monitoring for the sake of shareholders, in the case of public company. The introduction of the independent director mechanism during the second half of the twentieth century successfully changed or at least weakened managerial centrism and established the idea of shareholder supremacy. Shareholder supremacy and directors as fiduciaries then became part of common belief in the corporate world, shared by various levels of managers and employees in modern time even though they may not have independent directors on their board. As it became commonly-held, the level of monitoring has been collectively enhanced even for those companies with fewer or even none independent directors. Thus, the reality of

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extensive use of independent director in the United States reshaped the mentality of the business community as a whole, and in turn the way managers think and behave. Ultimately, to recognize shareholders as owners leads them to adopt a similar level of self-monitoring or internal control.

If this theory of spreading effect holds, it explains why some companies still enjoy enhanced performance even when they have fewer independent directors on their board: when the independent director mechanism is not directly implemented in some companies, the behavior of managers in those companies is still being affected by the whole environment and their counterparts in other companies. As the environment changes and the new concept is formed as a collective phenomenon, the difference in performance between companies with or without independent directors cannot be easily gleaned after mutual emulation in a long period of time. 237

d. The Link between Independence and Performance Revisited

The analysis of both sides of the argument needs to be placed in context with the role and the function of the independent director. First, the independent director is a mechanism designed to prevent management from abusing its authority, and it does so by remaining neutral to management. To some extent independent directors can use their expertise in other areas to help the company make better decisions. But this result can be easily purchased and obtained by retaining experts as consultants or employees. In terms of organizational design, monitoring, but not business expertise, should be the most important function that independent directors perform.

Although in theory it can be used to oversee daily business operations, the independent director mechanism, I argue, is especially designed for exceptional situations such as conflicts of interests or when incentive mechanisms for managers become extremely weak. In addition, when firms face emergency situations such as a crash in shareholder confidence after scandals or other crisis due to managers’ misconduct, independent directors can also help to appease the uncertainty and restore confidence by taking over control from previous managers. In those situations, the independent director mechanism can have functions that traditional insider boards

237 A similar view is expressed in Jeffrey Gordon’s article on the development and history of the independent director mechanism in the United States, in which he proposes that diminishing marginal returns and systematic effects are two reasons (along with tradeoffs and sorting) explaining why the statistical studies show the disconnection between board independence and firm performance. See Gordon, supra note 103, at 1507-09.
cannot. Since the reason that independent directors can have these functions is because they are from outside and nor related to interest conflict or managerial failure, it is evident that having persons from the outside who are less tied to insiders, financially or emotionally, is important.

In this way, the independent director acts like the company's fire extinguisher, which is most useful only in limited and extreme situation. It provides signals when systematic misconduct is taking place to equity investors, and is legally equipped with convenient tools to step in when necessary. In this sense, the contribution of the independent director would be preventive, and if those extreme situations are prevented as we hope for, there is no way to observe its use.

Paradoxically, if the above view holds, when a company succeeds and it reflects in better earning, it probably cannot be attributed to the independence directors’ effort, at least not directly, as independent directors’ function is mostly preventive and there must be a good management to produce profit. But if it fails, it means both management fail first and the monitoring mechanisms fail later also to change management. In the latter situation, the company will disappear and would not register in the statistics in the first place. To put it in a different way, in the success scenario, the adequate and proper monitoring brought by independent directors is a necessary factor but not a sufficient factor for better company performance; in the failure scenario, the absence of adequate monitoring is also a necessary factor since they do not make the right decision at the right time to change the poor management when it is present. In either event, the level of monitoring is either not a direct factor, or would not be clearly reflected in the statistics in any sense.

By definition, the elimination of potential misconduct will eventually lead to better performance. But conversely it may not make a significant difference when managers’ loyalty and prudence are not a major concern in a particular company. Even for companies whose managers are similarly loyal due to the same level of monitoring, their performance may still differ due to their different levels of sophistication, professional skill or even luck of those managers. Further, it takes a longer time before all other checks such as market, law, or check directly from equity owners to fail so that to have the chance to observe independent director’s effect as a preventive mechanism. But what is more important is that, characteristically, it is difficult to gauge how many potential errors or frauds independent directors help to deter if they have not had the chance to do so. In fact, it is relatively difficult, both in theory and practice, to gauge something that might happen but did not. Hypothetical causation is
built on theory and inference, but cannot be directly observed in factual investigation like statistical comparison, which leads to the conclusion that board composition is irrelevant to a company’s performance. This is especially true when the thing to be gauged is like corporate performance, in which the number of samples is relatively small and the results always involve many other variants, which are to a great extent idiosyncratic. In short, as a preventive mechanism, the independent director helps to avoid fraud or corporate misconduct; its function and contribution is different from the superior business on company performance. As a result, statistical studies focusing on how independent director contributes to company performance might be jumping too quickly to the conclusion and miss several important dynamics.

In addition, a longer period of time and a larger group of samples would be needed to provide a statistically meaningful result, since the mechanism's function is to reduce negative results, which is not always equal to creating surplus in absolute terms. If the samples are large and the coverage of time is long enough, it should be observable. But when the range of statistical investigation is too wide and the coverage of time is too long, other variables would be involved and blur the inference of causality. This makes it difficult to draw conclusions even when a certain result is being observed. Especially when the so called “negative” situations—situations that require intervention by the independent director mechanism—are generally incidental and can be averaged by the extended time, the statistical observation may become more difficult. In short, the value of the fire extinguisher cannot be readily judged by the contribution it brings to day-to-day life, but rather to exceptional situations, which are rare and hence difficult to measure.

To sum up, the ideal function of an independent director is two-fold. The first is to passively deter managerial misconduct, and the second is to step in actively when exceptional situations occur. Such situations include self-dealings, important decisions like mergers, and instances when management’s integrity or competency is questioned and management must be removed. In those cases, independent directors are replacing managers’ business judgments with those of their own. But as the word 'preventive’ suggested, these moments may be sporadic and rare. Even when it happens, the independent directors' ability to make management decisions is mostly supplementary, and the main purpose of this design is to prevent obvious mistakes or unfaithful conduct. This feature, both in terms of the frequency and the types of occasions when action is taken, in fact will substantially affect how the independent director mechanism is described in the statistical survey data.
Further, the independent director is one part of the whole monitoring network. Along with other monitoring mechanisms including criminal law, securities regulations, accounting inspection, market competition and direct monitoring from shareholders and other constituencies like debtors and employees, the independent director is part of a system of safety nets, and is not the first but is very likely the last net in terms of avoiding misconduct. In this sense, the lack of independent directors may be compensated for by other monitoring mechanisms. But on the other hand, it is similarly likely that if one piece of the safety net is missing, especially the independent director, it may trigger a chain reaction and lead to failure of the whole monitoring. Surely, where the absence of the independent director will lead is a question whose answer depends on multiple interactions among various monitoring mechanisms, and may vary from time to time as the environment changes.

This dynamic function may not be faithfully reflected and captured in a broad statistical investigation in terms of their contribution to increasing a company’s value. In this light, trying to establish a direct linkage between board independence and performance oversimplifies the role the independent director plays as a monitoring mechanism. If true, evaluation of the efficacy of the independent director should be conducted differently.

Surely the independent director has its limitations as a monitoring design. One of the most often raised criticisms is that independent directors only meets occasionally and does not monitor enough, i.e., it is merely window-dressing. But this criticism contains two meanings which require separate treatment. First, in practical term, it is true, as well as necessary, to consider how to elevate the function of the independent director to meet a higher standard and more challenging environment as a monitoring mechanism. However, below-the-bar performance or room for improvement does not automatically equal uselessness. Second, as a monitoring mechanism in the real world, its value should be determined in conjunction with observation of other comparable designs before any conclusion about its effectiveness is made. In other words, evaluation should be conducted in comparative, but not comparative, terms.

Other forms of independent monitoring, like auditing from outside accounting firms, securities periodical filing, or private litigations all have their benefits and limitations. For example, accountants might be bought out or influenced by managers; SEC filing
is generally procedural and does not cover all corporate decisions and their merit; private litigation is sporadic and sometimes may risk interfering with business unduly. In this light, the independent director mechanism plays a broad but central role among the various monitoring mechanisms. It is its central position, especially the right to select the CEO and collectively make fundamental decisions, that creates its comparative competitiveness and makes it dispensable. The same will hold true even from the perspective of different corporate environments, where supplemental monitoring mechanisms may be different but the basic corporate power setting stays the same.

V. CONCLUSION

At the first glance, the Japanese traditional two board system with corporate auditors, though inadequate and causing much discontent, appears to be standing strong in the face of challenges from the newly-introduced independent director. Upon deeper reflection, however, increased use of the independent director in Japan seems likely, even necessary. In this article, I demonstrate that recent cultural and economic changes provide a better environment, and impetus, to implement the independent director mechanism to a greater extent.

The above discussion of these big picture shifts provides a clearer understanding of why the independent director mechanism can serve the current environment better. The “cultural explanation” (various cultural factors help to solve corporate governance issues) which functioned in the past may not be as convincing today. The cultural explanation is in decline in Today’s Japan for two main reasons: (1) the growing discontent with self-entrenched managers and inadequate monitoring and the demand for a better intra-firm monitoring mechanism; and (2) the change of background structures as the result of post-Economic Bubble Era.

The traditional governance system in Japan, which mostly comes from inner-company checks and the professionalism of managers, is gradually weakening and becoming insufficient to meet the challenges of today’s economic reality. In this sense, a new type of monitoring system that focuses on a single company structure (but not the corporate group) is more likely to increase the level of monitoring.
Surely, one can conclude that the traditional Japanese system has been working adequately so far, if looking merely at the economic outcomes Japan has achieved in the past half of century after World War II. But there are several points needing further scrutiny. First, the fact that corporate auditors work as a separate body does not mean they are independent. Monitoring requires independence to perform adequate checks, and corporate auditors in Japan have lacked real independence in the past. Second, past experience with the corporate auditor has created a strong stereotyped image of corporate auditors as “voiceless team-players.” This makes reinventing or reinvigorating this mechanism very difficult, probably even more difficult than simply introducing a new system. Third, introducing a consolidated monitoring system will lead to better clarity, which is needed as economic affairs continue to get more complex. Lastly, the general trend seems to be moving toward a more fundamental change rather than sticking to the old path, which is more than half-century old.

Understandably, the introduction of the one-board structure does not mean the tension between shareholders and professional managers will be easily resolved. But compared to the two-board system, the one-board structure is better at addressing this tension by avoiding possible disagreements between directors and corporate auditors and confusion over the division of power and responsibility between the two boards. In the one-board structure, there is less room for ambiguity and the tension can be resolved by looking at which side has the majority. Either by vote (especially in the situation when the tension is from the conflicting interests among shareholders) or other methods like resignation, disagreement can be solved more easily: the majority has the say, and the other side can only turn to a third party, such as the court or shareholders, when the decision is seriously contested.

An alternative to importing independent director mechanism, conceivably, is to further amend the law and give Japanese corporate auditors the power to nominate or even select the CEO and director, as in the German dual structural model. But even leaving aside whether this modified dual board system will bring about more effective monitoring, the issues of overflow in corporate organs and resulting inefficiency still remain. Moreover, the modified dual board system compounds the attribution of responsibility, which often leads to a lower accountability in the end.

At this point, both independent directors and corporate auditors in Japan face their own limitations, internally and externally, especially when opposition from entrenched managers is strong. And as observed in this paper, 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 embarrassing stagnation. In this sense, it is still too early to confidently pinpoint what direction the Japanese independent director mechanism will take in next decade. Clearly, corporations’ use and perception of this mechanism are both keys to its future development. Legal scholars need to keep an eye on the independent director’s progress in Japan for the lessons it provides us about the complexities of legal transplants.