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A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law

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Modern theory of the corporation is infused with the notion of contract. The corporation is said to be a "nexus of contracts," a fictitious situs for a complex of relationships among suppliers of capital, labor, material factors of production, and managerial talent, on the one hand, and consumers of the firm's output on the other.[1] Styling the corporation as contract, in turn, presupposes some form of enforcement.[2] Enforcement mechanisms can be supplied by the state in the form of legal rules and institutions. They can also be supplied by the parties themselves in the form of contract, or by other products of human interaction in the form of markets, norms, and reputations.[3]

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1. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310–11 (1976). For a survey of the economic literature, see Bengt R. Holmstrom & Jean Tirole, *The Theory of the Firm*, *in* 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 63 (R. Schmalensee & R.D. Willig eds., 1989). For perspectives in the legal literature, see *Symposium, Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989) [hereinafter *Symposium*]. While the contractual approach to the firm is relatively new among Japanese scholars, some view the Japanese firm in essentially contractual terms. *See, e.g.*, Yoshiro Miwa, *Shijō ni okeru kyōsō no yakuwari [The Role of Market Competition]*, 1050 JURISUTO 94 (1994); NIHON NO KIGYŌ [THE JAPANESE FIRM] (Kenichi Imai & Ryūtarō Omiya eds., 1989).

This approach is not without its detractors in the United States or Japan. *See, e.g.*, Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) (arguing that contractual analysis of shareholder-manager relations is flawed and ideologically driven); Katsuhiko Iwai, *Kigyōkeizairon to kaisha tōji kikō [Economic Theory of the Firm and Corporate Governance]*, 1364 SHŌJI HŌMU 7 (1994) (critical assessment of nexus of contracts approach).

2. Anthony T. Kronman, *A Comment on Dean Clark*, 89 COLUM. L. REV. 1748, 1748–49 (1989).

3. *See, e.g.*, Abram Chayes, *The Modern Corporation and the Rule of Law*, *in* THE CORPORATION

As a result, the firm operates under a series of constraints comprised of legal rules, markets, and private ordering.[4] Legal rules typically shape the basic structure of corporate organs, define the rights of corporate actors, and set the boundaries for private ordering. But private deals worked out among corporate actors put flesh on the skeleton of legal rules. Competition in capital, control, product, and managerial markets disciplines managers and shrinks the divergence of interests between dispersed and rationally disengaged shareholders and the professional managers who actually control the corporation. Under certain conditions, contracts can be self-enforcing because adherence to the terms of an agreement is more advantageous than violation.[5]

The corporate contract is embedded in a rich social and legal environment,[6] and different environments naturally give rise to different patterns of relationships and enforcement mechanisms. The spectrum of corporate constraints available—ranging from formal rules of the legal system to economic and social forces—is everywhere the same. It is the *balance* of constraints utilized that differs considerably across societies.

It is in the balance of constraints that corporate governance mechanisms in the United States and Japan appear to differ so dramatically. Private ordering figures prominently in explanations of Japanese economic life; in most accounts, law is conspicuous by its absence.[7] The Japanese firm, for example, is often styled as a reflection of unique

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IN MODERN SOCIETY 25 (Edward S. Mason ed., 1961) (discussing legal, contractual, and market constraints on corporate power); David M. Kreps, *Corporate Culture and Economic Theory*, *in* PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 90 (James E. Alt & Kenneth A. Shepsle eds., 1990) (modeling reputation as a corporate monitoring and control mechanism).

4. *See* Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 380–92 (1990) (describing the "nexus of constraints" on corporations).

5. L.G. Telser, *A Theory of Self-enforcing Agreements*, 53 J. BUS. 27, 27–28 (1980) ("A self-enforcing agreement between two parties remains in force as long as each party believes himself to be better off by continuing the agreement than he would be by ending it . . . . Since it is costly to rely on the intervention of third parties such as the courts to enforce agreements and to assess damages when they are violated, the parties to an agreement devise its terms to make it self-enforcing, if this can be done cheaply enough.").

6. *See, e.g.*, Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 894 (1990) ("the very practice of contracting in markets is grounded on noncontractual social and legal values"); Thomas Lee Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273, 278 (1991) ("[W]e must not forget that corporations are not simply economic institutions; they are also political and social institutions.").

7. A prominent exception is the work of Professor Mark Ramseyer. *See* J. Mark Ramseyer, *Legal Rules in Repeated Deals: Banking in the Shadow of Defection in Japan*, 20 J. LEGAL STUD. 91 (1991) [hereinafter Ramseyer, *Repeated Deals*] (asserting that law plays an important role in the Japanese banking industry); J. Mark Ramseyer, *Explicit Reasons for Implicit Contracts: The Legal Logic to the Japanese Main Bank System*, *in* THE JAPANESE MAIN BANK SYSTEM 231 (Masahiko Aoki & Hugh Patrick eds., 1994) [hereinafter Ramseyer, *Legal Logic*] (questioning the theory that the main bank system operates on the basis of implicit contracts).

cultural traits—the family writ large.[8] As in any ideal family, relationships are said to be based on cooperation and trust; formal rules and institutions pale in importance next to reputation. In Japan, we are often told, "law and lawyers do not play a significant part in the decision-making and enforcement mechanism[s] underlying Japanese cooperation. For the Japanese, cooperation is not based on legal coercion."[9]

Indeed, nothing we hear about corporate Japan suggests a major role for law. Firms are woven into seamless webs of affiliated groupings that hold reciprocal blocks of stock and engage in an ongoing series of transactions. Banks monitor industry and intervene voluntarily to rescue troubled borrowers. After hours, bureaucrats and businessmen devise industrial policy over cups of *sake*. All of this supposedly occurs without the bothersome American rituals of contracts, courts, and corporate lawyers. Harmony and consensus, after all, are hardly the typical by-products of the strike suit, the bond indenture, or the seventy-five-page form contract.

Contrast the American corporation. Here, though the proper role for law in the nexus of constraints is the subject of intense debate,[10] few would argue that legal rules and institutions are not integral to the governance of large firms.[11] Not surprisingly, since "judges are now at the center of the American system of corporate governance,"[12] Japan offers an appealing vision of a land where the legal system remains aloof from matters of corporate organization and monitoring.[13]

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8. *See, e.g.*, Dan Fenno Henderson, *Security Markets in the United States and Japan: Distinctive Aspects Molded by Cultural, Social, Economic, and Political Differences*, 14 HASTINGS INT'L & COMP. L. REV. 263, 280–89 (1991); JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 70–74 (1994).

9. David Broiles, *When Myths Collide: An Analysis of Conflicting U.S.-Japanese Views on Economics, Law, and Values*, 1 TEX. WESLEYAN L. REV. 109, 117 (1994). *See also* Arthur T. von Mehren, *Some Reflections on Japanese Law*, 71 HARV. L. REV. 1486 (1958) (Confucian thought and preference for smoothness in human relations account for fact that law plays far less pervasive role in Japan than in the West).

10. For different views on this issue, see *Symposium, supra* note 1.

11. *See, e.g.*, CHARKHAM, *supra* note 8, at 357 (describing the "unheavenly trio of derivative suits, class actions, and contingency fees . . . unique to the USA"). Even the staunchest contractarians admit to a significant role for the state in supplying the "standard form contract" and the judiciary to fill in gaps in the contract ex post. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). One prominent commentator has argued that courts form the mandatory core of U.S. corporate law. *See* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989).

12. Jonathan R. Macey, *Courts and Corporations: A Comment on Coffee*, 89 COLUM. L. REV. 1692, 1701 (1989).

13. *Id.* It is tempting to take the firm as a microcosm of the society in which it operates, and to find in corporate America confirmation of the supposedly overlawyered and overlitigated U.S. environment. *See* Marc S. Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV.

Why is the corporate contract in Japan apparently enforced so rarely through legal mechanisms? Most discussions of Japanese corporate governance rest on the implicit or explicit assumption that enforcement through the legal system is unnecessary or unavailable in Japan. It is asserted, for example, that a Confucian moral order mitigates self-interest and opportunism in Japan[14] and that an aversion to legal rules and institutions drives parties to cooperate informally, rather than through legally enforceable contracts.[15] Scholars quite plausibly explain primary institutions of Japanese corporate governance as efficient responses to weaknesses in the Japanese legal system.[16] Commentators suggest, for example, that bank-centered corporate groups substitute for underdeveloped contract enforcement mechanisms.[17] Others hy-

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4, 57 (1983) (Japan "appears in contrast [to the United States] as a peaceful garden that has remained uncorrupted by the worm of litigation.").

14. Ronald Dore, *Goodwill and the Spirit of Market Capitalism*, 34 BRIT. J. SOC. 459 (1983); CHARKHAM, *supra* note 8, at 74 (arguing that consensus in Japan is that preservation and prosperity of family-like company is more important than profit maximization; "financial opportunism so evident in the 1980s in the UK and USA was and would be anathema in Japan").

15. These theories reflect powerful and pervasive themes in Japanese law. Fundamental to the conception of Western and Asian legal systems is the notion that the latter commit fewer issues to formal legal resolution. One of the most widely read articles on Japanese law argues that the "legal consciousness" of the Japanese does not coincide with Western notions of contract, or with the European-inspired formal codes in Japanese law that give effect to contracts. *See* Takeyoshi Kawashima, *The Legal Consciousness of Contract in Japan*, 7 LAW IN JAPAN 1 (1974) (Charles R. Stevens, trans.). In this view, law is inimical to the ethos of harmony and consensus that infuses relationships in Japan. Thus, in contrast to "Westerners who see contractual rights and duties as something fixed and definite," *id.* at 17, the Japanese hesitate to make explicit rights and duties at the outset of a contractual relationship, *see* Toshiro Nishimura, *The Relational Contract and Japanese Legal Consciousness*, *in* UNITED STATES/JAPAN COMMERCIAL LAW AND TRADE 696, 698 (Valerie Kusuda-Smick ed., 1990), and prefer to resolve disputes by mutual understanding and accommodation. Similar views are of course often expressed by non-Japanese commentators. *See, e.g.*, ROBERT J. BALLON, THE BUSINESS CONTRACT IN JAPAN, Sophia University Institute of Comparative Culture, Business Series Bulletin No. 105 (1985).

Professor John Haley offers a more refined explanation for the different approaches to contract that casts the roles of culture and law in a different light. Professor Haley argues that weak law enforcement leads to strong mechanisms of social control. If courts cannot be counted upon to enforce private bargains, written agreements will serve more as memoranda of agreement between parties than as legal instruments contemplating enforcement and interpretation by the courts. John O. Haley, *Legal vs. Social Controls*, 17 LAW IN JAPAN 1, 4 (1984). In contrast to commentators who stress "unique" cultural traits of the Japanese, Haley is careful not to suggest that law loses relevance in Japan. In his view, law, though unenforced, is a crucial policy instrument utilized to shape consensus. *Id.* at 5–6.

16. *See, e.g.*, ERIC BERGLOF & ENRICO PEROTTI, THE JAPANESE FINANCIAL KEIRETSU AS A COLLECTIVE ENFORCEMENT MECHANISM (Massachusetts Institute of Technology Working Paper, 1991); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 899 (1993). An influential theoretical basis for these hypotheses can be found in the work of Professor John Haley, who argues that highly efficacious social norms substitute for a weak legal system in Japan. *See* John O. Haley, *Sheathing the Sword of Justice in Japan: An Essay on Law without Sanctions*, 8 J. JAPANESE STUD. 265 (1982); Haley, *supra* note 15, at 3 ("corollary to the underlying weakness of law enforcement in Japan is the remarkable strength and effectiveness of social restraints").

17. *See* Berglof & Perotti, *supra* note 16, at 3 (advancing the hypothesis that an undeveloped

pothesize that a *keiretsu*-oriented system of monitoring and competition developed in Japan because "cultural traits handicap the effective use of a detailed contract . . . . If law is weak, alternatives must be found."[18] Similarly, discussions of Japanese bank involvement in corporate finance and control typically focus exclusively on its extra-legal character.[19] Japanese corporate governance, it would appear, rests on a foundation of culture, not contract.

For all of their plausibility and appeal, these explanations are somewhat misleading. Although at one level there is considerable reliance on informal mechanisms to organize and monitor economic activity in Japan, a closer analysis reveals that law plays a significant role in shaping the institutions of Japanese corporate governance. Law is crucial to the framework for private economic ordering. Existing explanations also mislead by overlooking a substantial body of judge-made law that reinforces relationships and enforces agreements in corporate settings. And perhaps most seriously, they mislead by supplying static explanations of law's place in the nexus of corporate constraints; in fact, recent developments portend a potentially fundamental shift in the Japanese legal environment.

In this Article, I seek a better understanding of the intersection between legal rules, social norms, markets, and private ordering mechanisms in the governance of the Japanese firm. The Article has three main aims. The first is to provide a detailed theoretical explanation for the less prominent role played by the corporate and securities laws in Japan than in the United States. Second, and more importantly, the Article demonstrates that law is nonetheless critically important in the creation and sustenance of Japanese corporate governance mechanisms. Indeed, the Article shows that corporate constraints are strongest in precisely those areas in which law has played the largest role in shaping relationships in corporate Japan. Although scholars often speculate about the weakness of Japanese law, I will offer an explanation of Japanese corporate governance that is fully consistent with both a highly effective legal system and U.S. approaches to contract. Finally,

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notion of contract and a lack of state enforcement led to the emergence of corporate groups as an informal mechanism of contract enforcement).

18. Gilson & Roe, *supra* note 16, at 899.

19. *See, e.g.*, Paul Sheard, *Reciprocal Delegated Monitoring in the Japanese Main Bank System*, 8 J. JAPANESE & INT'L ECON. 1 (1994) (arguing that banks abide by an elaborate and legally unenforceable "main bank contract" requiring monitoring of firms); David G. Litt et al., *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369, 443 (1990) (discussing extra-legal moral arrangements in Japanese banking that "appear as binding as any legal contract"); Toshihiro Matsumura & Marc Ryser, *Revelation of Private Information About Unpaid Notes in the Trade Credit Bill System in Japan*, 24 J. LEGAL STUD. 165 (1995) (discussing extra-legal enforcement in bank clearinghouse system for promissory notes).

the Article highlights the dynamism of institutions and law in Japanese corporate affairs—dynamism that, I argue, is motivated by changes in underlying corporate relationships.

To accomplish these aims, I place the Japanese firm[20] in relational perspective.[21] I show that while the Japanese firm has long remained aloof from the corporate and securities laws designed to structure corporate conduct, law plays a major and increasingly important role in Japanese corporate governance. Since most observers have focused on the absence of legal controls in Japan, law remains underconceptualized and largely static in much of the existing literature, obscuring a complete view of the forces that shape major actors at the center of the Japanese economy. Relational theory contributes to existing scholarship by recognizing both socio-cultural influences on Japanese firm behavior, as well as the efficiency rationales advanced by economic theorists. It also provides an explanation that captures both the highly significant and increasingly prominent role of the legal system in the governance of the Japanese firm. If corporate finance, monitoring, and control mechanisms are path dependent, they are subject to change. Understanding the dynamism of institutions thus becomes critical.[22]

The Article is organized into five parts. Part I constructs the theory that relationships define the firm and influence the legal order, and it considers the implications of relational theory for comparative corporate governance. Part II explores the sharp divergence between the legal rules designed to govern Japanese corporations on the one hand, and the actual institutions of Japanese corporate governance on the other. This Part demonstrates how relational governance has rendered irrelevant *some* of the legal framework for Japanese corporate governance

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20. The Article deals only with large, joint stock companies (*kabushiki kaisha*).

21. Numerous scholars view the U.S. corporation as a species of relational contract. *See, e.g.*, Coffee, *supra* note 11, at 1625 ("[T]he corporate charter is the extreme example of a relational contract . . . ."); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U. L. Rev. 854, 890 n.114 (1978) ("The corporate firm is no more and no less . . . than an immensely complex bundle of ongoing contractual relations."); Easterbrook & Fischel, *supra* note 11, at 90 ("Corporations are enduring (relational) contracts.").

Some commentators have applied relational analysis to Japanese corporate governance. Ronald Gilson and Mark Roe have shown how shareholding and financing patterns among the *keiretsu* create overlaps between industrial production, monitoring, and discipline in a system they label "contractual governance." Gilson & Roe, *supra* note 16, at 871. *See also* W. Carl Kester, Japanese Takeovers: The Global Contest for Corporate Control 53–81 (1991). Other commentators have noted the importance of relational contracting theory to our understanding of Japanese economic behavior. *See, e.g.*, Daniel H. Foote, *Evolution in the Conception of Contracts*, *in* United States/Japan Commercial Law & Trade, *supra* note 15, at 689, 691; John O. Haley, *Luck, Law, Culture and Trade: The Intractability of United States-Japan Trade Conflict*, 22 Cornell Int'l L.J. 403, 416–19 (1989).

22. *See* Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 Wash. U. L.Q. (forthcoming 1996).

and illustrates how extensive corporate cooperation has constrained the development of Japanese corporate and securities laws. Notwithstanding the apparent irrelevance of law, Part III develops the critical insight that law actually facilitates the extensive cooperation described in Part II. Part III thus shifts the focus to other, highly effective, but largely overlooked legal constraints on corporate Japan. Specifically, it shows that capital market regulation, legal enforcement of the good faith principle, and judicial gloss on employee tenure and job rotation practices play a significant role in compelling or encouraging long-term economic relationships. Part IV examines evidence suggesting that the nexus of constraints on the Japanese firm is shifting in the face of powerful domestic and international forces. Consistent with relational theory's predictions, as relationships break down at each level of the Japanese corporation, legal rules, procedures, and institutions are beginning to play an increasingly important role in Japanese corporate governance. These developments have the potential to fundamentally alter the legal environment in which the Japanese firm operates. Concluding remarks follow in Part V.

I. CONTRACTUAL RELATIONS AND CORPORATE CONSTRAINTS

Before examining the Japanese corporate contract in detail, this Part constructs the theoretical prism through which the law and practice of corporate activity will be viewed in succeeding Parts. The implications of the theory for comparative corporate governance developed in this section set the agenda for the remainder of the Article.

"Corporations," as a leading commentator puts it, "have always been exchange relations writ large."[23] The firm is a complex governance structure organized to economize on the multitude of relations entered into between corporate constituents, such as shareholders and managers, debtors and creditors, and suppliers and customers.[24] Some relations between corporate constituents will come close to approximating

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23. Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483, 493 (1985).

24. Ronald Coase was the first to view the boundaries of the firm as a function of transaction costs. Coase saw that economic activity will be organized within a firm when that mechanism is superior to fully specified contracting on a repeated basis. Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

Oliver Williamson has elaborated on Coase's pioneering insight, demonstrating that the central imperative of governance structures is to economize on the transaction costs associated to varying degrees with all real-world exchange. *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (1985) [hereinafter WILLIAMSON, ECONOMIC INSTITUTIONS]; OLIVER E. WILLIAMSON, ECONOMIC ORGANIZATION: FIRMS, MARKETS AND POLICY CONTROL 176–78 (1986) [hereinafter WILLIAMSON, ECONOMIC ORGANIZATION].

perfect-world "frictionless" exchange.[25] These are one-shot deals requiring little ongoing cooperation. Most corporate relations, however, will deviate from this ideal,[26] involving exchange of longer duration, where substantial firm-specific investments of human or physical capital are made.[27] These more complex contracts will require more complex governance structures.[28] In the terminology of relational contract theory, corporate contracts range from discrete to relational.[29] It is in this sense that the firm is a "nexus of contracts."

Enduring patterns of contractual relationships, in turn, generate norms[30] that channel the behavior of corporate actors.[31] In this way, the firm takes on a life separate from the deals struck by constituent

25. In a perfect world, exchange is "frictionless": the future is knowable, promises are kept, and each exchange is unencumbered by past associations or ongoing obligations. Without friction, contracting is vastly simplified. WILLIAMSON, ECONOMIC ORGANIZATION, *supra* note 24, at 176–77. But the world is not perfect. Promises are broken, human cognition is limited, and exchange often occurs within a substantial preexisting framework that entangles the parties in a history of shared associations and expectations. Thus, transaction costs in the form of "bounded rationality" (uncertainty about the future), "opportunism" (self-interest seeking with guile), and "asset specificity" (the degree to which an asset's value depends on the continuation of a particular relationship) are ever present in real world contracting. *See* WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 24, at 43–67. Economic actors build compensating regimes to minimize these costs. Thus, "[g]overnance structures—the institutional matrix within which transactions are negotiated and executed—vary with the nature of the transaction." Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233, 239 (1979) [hereinafter Williamson, *Transaction-Cost Economics*].

26. Oliver E. Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1199 (1984).

27. Williamson, *Transaction-Cost Economics*, *supra* note 25, at 239–40.

28. *Id.* at 250–53. *See also* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1089–95 (1981) (describing use of perfectly contingent contracts and relational contracts as a function of transaction costs).

29. Relational contract theory begins with two basic concepts: society and exchange. Ian R. Macneil, *Relational Contract Theory as Sociology: A Reply to Professors Lindenberg and de Vos*, 143 J. INST'L & THEORETICAL ECON. 271, 278 (1987) [hereinafter Macneil, *Relational Contract Theory*]. Specialization inherent in economic activity gives rise to exchange; all exchange is embedded in social relations. Ian R. Macneil, *Reflections on Relational Contract*, 141 J. INST'L & THEORETICAL ECON. 541, 542 (1985).

All exchange ranges along a spectrum from discrete to relational. "Discrete contracts are characterized by short duration, limited personal interactions, and precise party measurements of easily measured objects of exchange. They require a minimum of future cooperation between the parties . . . . The parties are bound precisely and tightly. The parties view themselves as free of entangling strings." Macneil, *Relational Contract Theory*, at 275. Relational contracts are more durable, flexible, and complex, involving multiple facets of the parties' existence. The participants "view the relation as an ongoing integration of behavior which will grow and vary with events in a largely unforeseeable future." Ian R. Macneil, *Restatement (Second) of Contracts and Presentiation*, 60 VA. L. REV. 589, 595 (1974) [hereinafter Macneil, *Contracts*]. "In the 'relational view' . . . parties treat their contracts more like marriages than like one-night stands." Robert W. Gordon, *Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1985 WIS. L. REV. 565, 569 (1985).

30. Macneil, *supra* note 21, at 901.

31. William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 214 (1992) (arguing that corporate decision-makers "strive to employ norms consonant with those woven into the fabric of relationships corporate actors bring to them").

actors. It is contract transformed into an institution.[32] Thus, in contrast to the purely contractarian approach, the firm may be best viewed as an institutionalized network of norm-generating relationships. The institution is itself embedded in a larger historical, social, and political framework shaped out of past and present relations.

Viewing the firm in this way has critical implications for the study of comparative corporate governance. First, it expands the focus of inquiry beyond formal enforcement mechanisms supplied by the state and reminds us that legal rules are but one constraint in any society. In a complex world of long-term relations and substantial transaction costs, resort to the legal system for enforcement will be infrequent:[33] "This is the world of governance in which court ordering is no longer assumed to be effective. The institutions of private ordering thus command centre stage."[34] The notion that the rules and institutions of the formal legal order respond imperfectly to the real world of exchange, and that all exchange is embedded in a social order of which law is but one type of sanction, suggests that "[i]n sustained relationships, the effectiveness of agreements rests primarily upon factors other than the intervention of the State."[35] Private ordering, in other words, pervades economic transactions in all societies: relationships are often a lower cost substitute for other forms of governance.[36]

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32. *See* Gidon Gottlieb, *Relationism: Legal Theory for a Relational Society*, 50 U. CHI. L. REV. 567, 586 (1983); William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395 (1993).

33. A substantial body of literature, beginning with Stuart Macaulay's famous study of Wisconsin businessmen, confirms that private parties seldom invoke formal legal rules and coercive state sanctions to order conduct or to settle disputes within diffuse, long-term relationships. Stuart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963); *see also* Macneil, *supra* note 21, at 901 (arguing that as the duration and complexity of exchange increase, the neoclassical contract system is replaced by a very different adjustment process); Gordon, *supra* note 29, at 569 ("In the 'relational view' of Macaulay and Macneil, ... the object of contracting is not primarily to allocate risks, but to signify a commitment to cooperate. In bad times the parties are expected to lend one another mutual support, rather than standing on their rights."); Robert C. Ellickson, *A Critique of Economic and Sociological Theories of Social Control*, 26 J. LEGAL STUD. 67, 92 (1987) ("[I]nformal controls always supplement and often supplant the legal system.").

34. WILLIAMSON, ECONOMIC ORGANIZATION, *supra* note 24, at 178.

35. Gottlieb, *supra* note 32, at 570.

36. *See* Douglass C. North, *Institutions and a Transaction-Cost Theory of Exchange*, *in* PERSPECTIVES ON POSITIVE POLITICAL ECONOMY, *supra* note 3, at 182, 193 ("Third-party enforcement is never ideal, never perfect, and the parties to exchange still devote immense resources to attempting to clientize exchange relationships."); Marc Galanter, *Justice in Many Rooms: Courts, Private Ordering, and Indigenous Law*, 19 J. LEGAL PLURALISM 1 (1981) (discussing "overcommitment" of law and resulting delegation of power to lower level groups); ROBERT C. ELLICKSON, ORDER WITHOUT LAW 280–83 (1991) (asserting that transaction costs impose limits on the law).

Recognition of this point can be found in the pioneering work of both U.S. and Japanese legal scholars. Stewart Macaulay found that legally enforceable contracts are not the glue that holds together most business deals. Legal sanctions pale in importance next to norms that both discourage welshing on a deal and encourage production of good products, personal relationships

Firm-specific investments of physical or human capital by corporate constituents are exit barriers that reinforce relational governance structures.[37] Where such investments are substantial, mechanisms other than legal rules will be used more often to ensure performance.[38] Similarly, where interaction between governmental authorities and the private sector is close and ongoing, regulatory activity will be more informal than where contact is adversarial and infrequent. The point is as obvious as it is fundamental: if resort to law damages a relationship, parties with substantial investments in a relationship will be less likely to invoke formal legal mechanisms. Thus, an informal, iterative game breaks down principally where a relationship encounters "final period" problems: if one party seeks to terminate dealings, rationally it will no longer consider the impact of its conduct on the relationship. Greater resort to litigation can therefore be expected upon exit from a relationship than in other situations.[39]

Second, notwithstanding the pervasiveness of private ordering in most situations, the state can support exchange relationships in a variety of formal and informal ways. In order to realize the full significance of law in Japanese corporate governance, the entire range of ways in which the state interacts with the private sector must be examined. Limited resort to formal enforcement may not imply legal weakness.[40] The state may instead be performing a powerful legal function by "creating an effective set of rules that then enhance[s] a variety of effective informal constraints."[41] Indeed, a basic function of

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between the transacting parties, and most basically, the mutual desire to continue doing business in the future. Macaulay's study suggests that not only are law and lawyers often ignored by businessmen, they are often thought to stand in the way of good business relations and successful conclusion of a deal by destroying trust and diminishing flexibility. Gains from litigation over a particular dispute may be far outweighed by the cost to the relationship. Macaulay, *supra* note 33, at 62–65. Similarly, even in the influential work of Professor Takeyoshi Kawashima, which stresses cultural factors to explain the apparent reluctance of the Japanese to utilize law and legal instruments to enforce bargains, one can find suggestions that the nature of a relationship will have a significant impact on the degree to which formal legal mechanisms will order a transaction. Kawashima, *supra* note 15, at 19–20.

37. *See* Victor P. Goldberg, *The Law and Economics of Vertical Restrictions: A Relational Perspective*, 58 TEX. L. REV. 91 (1979).

38. Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 269 (1986).

39. Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 526–28 (1981).

40. Most commentators who posit a weak Japanese legal system either fail to explain what is meant by this term or focus on cultural proclivities or defects in formal enforcement mechanisms that limit resort to legal institutions. Yet if "weakness" means the inherent limitations of legal enforcement mechanisms in securing cooperation, see Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597 (1990), then all legal systems suffer this defect and the term loses descriptive power as applied specifically to Japan. A relational perspective turns the inquiry on its head: if, as so many observers report, the Japanese rely heavily on the cooperative norm, how has the legal system supported cooperative social and economic action?

41. North, *supra* note 36, at 194.

the state is to provide the rules of the game in order to specify the terms of competition and cooperation, on the one hand, and to reduce transaction costs to maximize social output on the other.[42] The rules of the game include who is allowed to play, for how long, and the relative power of the competing teams. These rules, in turn, promote or impede cooperation.[43] To test the effectiveness of Japanese law, any legal rules that structure corporate relations should be examined.[44] In looking principally to the familiar indices of law's role in structuring society, such as the number of lawyers, the extent and strength of judicial remedies, and the use of formal legal instruments, even the most careful observers of Japanese law may have overlooked equally important manifestations of a highly effective legal order.

Third, since corporations are a species of relational contract, the context[45] and history[46] of exchange is of great importance in understanding how corporations are organized and monitored. This is particularly true in analyzing the firm in a foreign society, which does not share a common context and history with more familiar domestic institutions. The significance of this point is emphasized by recent scholarship that recognizes that the development of law and legal institutions–including corporate law–is path dependent.[47] Corporate governance structures are historically and politically contingent.[48] Therefore, different societies may "lock in" on different legal and institutional regimes through historical accident and the vagaries of shifting political and social undercurrents. From this premise follow two major hypotheses to be tested using the Japanese example. First, multiple

42. DOUGLASS C. NORTH, STRUCTURE AND CHANGE IN ECONOMIC HISTORY 20–32 (1981).

43. This is a paraphrase of Robert Ellickson's insightful discussion of the way that law influences informal social controls. *See* ELLICKSON, *supra* note 36, at 284–86.

44. *Cf.* Gordon, *supra* note 29, at 573 (asserting that "from the relational perspective, any body of law that helps to structure contracting behavior should be considered as part of contract law.").

45. *See* Robert A. Hillman, *The Crisis in Modern Contract Theory*, 67 TEX. L. REV. 103, 124 (1988) ("[O]ne must investigate the social conditions that form the foundation of parties' bargains in order to comprehend the relational norms and hence to understand contract.") (citing Macneil, *Contracts*, *supra* note 29, at 595).

46. *See* Paul Sheard & Christopher Findlay, *Japanese Corporate Organization in International Perspective*, *in* INTERNATIONAL ADJUSTMENT AND THE JAPANESE FIRM 11, 15 (Paul Sheard ed., 1992) ("The actions that economic agents take in a particular period are influenced by the nature of economic organization in which they operate and this in turn reflects decisions, contracts and commitments from previous periods.").

47. On the importance of institutional frameworks for the existence of different equilibrium paths for Japanese and U.S. firms, see Masahiko Aoki, *The Japanese Firm as a System of Attributes: A Survey and a Research Agenda*, *in* THE JAPANESE FIRM: THE SOURCES OF COMPETITIVE STRENGTH 11, 27–33 (Masahiko Aoki & Ronald Dore eds., 1994). For an argument that a path-dependent approach to Japanese corporate governance misses the most important source of the constraints on Japanese firms, see Steven N. Kaplan & J. Mark Ramseyer, *Those Japanese Firms with Their Disdain for Shareholders: Another Fable for the Academy*, 74 WASH. U. L.Q. (forthcoming 1996).

48. Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991).

structural equilibria are possible,[49] so that firms in different economies will be governed effectively utilizing quite different balances of constraints. Second, the nexus of corporate constraints is dynamic, shifting with movements in the underlying socio-economic framework in which the firm is embedded.[50]

II. DISCRETE LAW, RELATIONAL GOVERNANCE

> *Which requirements should be considered most important in the present efforts of the government in building Japanese industries? It can be neither capital nor laws and regulations because both are dead things in themselves and totally ineffective. The spirit sets both capital and regulations in motion . . . .*[51]

In comparison to the United States, corporate and securities laws do indeed play less prominent roles in Japanese corporate governance.[52] Thus, the frequent resort to cultural explanations of Japanese corporate governance by prior commentators is understandable. Legal culture may in fact provide a powerful explanation for this phenomenon. This Part, however, suggests that we have been looking at the wrong legal culture to provide these explanations. When United States corporate and securities laws were imported into Japan they were severed from their intellectual moorings. The atomized, depersonalized shareholder-manager relationship that animates U.S. law and colors our view of the corporate contract has never resonated among Japanese institutions. Hence, the U.S.-inspired legal framework for Japanese corporate governance has traditionally played little role in the nexus of constraints on the Japanese corporation. Instead, corporate monitoring and discipline are provided by a highly relational order.

49. Given the economic success of Japan, if we accept the premise that corporate governance is path dependent, we need to reassess the notion that path dependence and lock-in imply inefficiency. *See* W. Brian Arthur, *Competing Technologies, Increasing Returns, and Lock-In by Historical Events*, 99 ECON. J. 116 (1989) (cautioning that the selection of equilibrium from multiple candidates by historical events and economic forces can cause an economy to lock in to an inferior outcome).

50. *Cf.* Bratton, *supra* note 31, at 214 (asserting that corporate norms in the U.S. context are dynamic: "Rules articulated in the past remain appropriate only to the extent that future corporate practices repeat past patterns.").

51. KŌGYŌ IKEN (1884) (the first economic white paper of the modern Japanese government), *quoted in* JOHANNES HIRSCHMEIER & TSUNEHIKO YUI, THE DEVELOPMENT OF JAPANESE BUSINESS 1600–1973, at 76–77 (2d ed., 1981).

52. *See infra* notes 101–160 and accompanying text.

A. *The (Misleading) Legal Framework for Corporate Governance in Japan*

The basic statutory framework for Japanese corporate governance is of almost wholly imported origin. Japan's Commercial Code,[53] which contains the Company Law supplying the basic rules for the establishment and conduct of corporate entities, was originally based on the German model. It was extensively amended in the early postwar period under the influence of the American Occupation authorities.[54] Japan's principal securities statute[55] is closely modeled after the United States federal securities laws. Thus, following the war, with one major exception,[56] the constituent organs of the Japanese corporation and the basic rules for its organization and governance took on a highly American cast.[57]

As in the United States, Japanese corporations are organized in part by mandatory structural and fiduciary rules that guide the internal processes of corporate decision-making and the external conduct of corporate actors.[58] The rules provide for a board of directors elected by

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53. SHŌHŌ [COMMERCIAL CODE], Law No. 48 of 1899.

54. In fact, the Company Law as amended in 1950 was modeled after the Illinois Business Corporation Act of 1933. This was not due to any particular superiority of that statute, but rather to the fact that the Occupation reformers in charge of the revision happened to be members of the Illinois bar. Thomas L. Blakemore & Makoto Yazawa, *Japanese Commercial Code Revisions*, 2 AM. J. COMP. L. 12, 15 (1953). The 1950 amendments effected three principal changes in the Company Law. They instituted a board of directors designed to perform management functions by representative directors [*daihyō torishimariyaku*], and monitoring functions by the full board. Second, they made changes in the statutory auditor system, *see infra* note 56, to account for the creation of the board. Third and most importantly in the eyes of the Occupation reformers, code provisions relating to the rights and remedies of shareholders were strengthened. Shareholders were afforded appraisal rights and granted additional powers to participate in and oversee management. The duties of directors to shareholders were expanded, the derivative suit mechanism was liberalized, and 10% shareholders were given the right to inspect corporate books. For a discussion of the Occupation-instituted Company Law reforms, *see id.*; Lester N. Salwin, *The New Commercial Code of Japan: Symbol of Gradual Progress Toward Democratic Goals*, 50 GEO. L.J. 478 (1962).

55. Shōkentorihikihō [Securities and Exchange Law], Law No. 25 of 1948 [hereinafter SEL].

56. A major exception is the institution of statutory auditor [*kansayaku*]. The statutory auditor is a distinctly Japanese corporate organ with roots in the German *Aufsichtsrat*. While the institution's powers have waxed and waned periodically since its creation with the adoption of the Commercial Code in 1899, the statutory auditor's primary objective is to represent shareholders and to ensure protection of their interests by monitoring managements' compliance with law and the company's articles of association. Auditors are selected by and removable at the will of the shareholders. *See* COMMERCIAL CODE arts. 273–280 for the qualifications, duties, and liabilities of statutory auditors.

57. Of course, significant systemic differences between the two countries create important corporate law distinctions. Specifically, Japan has a unitary political system. Thus, unlike corporations in the United States, which are creatures of state law, Japanese joint stock companies [*kabushiki kaisha*] are registered with the Minister of Justice. Moreover, in the civil law tradition, a single Company Law within the Commercial Code prescribes the basic rules of corporate establishment and internal organization.

58. On the U.S. corporation, see Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); on the Japanese corporation, *see* Hiroyuki Kansaku, *Kōporēto*

shareholders for a limited term of office to serve as the basic governing organ.[59] Liability rules govern the relationship between the directors and the corporation.[60] Aggrieved shareholders have access to the courts to enforce these rules.[61] Other rules give shareholders a voice in corporate affairs;[62] require periodic disclosure of reliable financial data;[63] regulate transactions that raise potential conflicts of interest between managers and the corporation;[64] and protect the integrity of shareholder voting.[65]

The Securities and Exchange Law (SEL) also subjects the Japanese corporation to extensive rules concerning conflicts of interest and mandatory disclosure designed to protect investors.[66] For example, under the SEL, a corporation's officers, agents, and employees may not trade in the corporation's securities on the basis of material undisclosed information.[67] Officers and shareholders owning at least ten percent of

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gabanansu to kaishahō no kyōkō hōkisei [*Corporate Governance and the Mandatory Nature of the Company Law*], 1050 JURISUTO 130 (1994); Hideki Kanda, *Kabushiki kaishahō no kyōkō hōkisei* [*The Mandatory Nature of the Company Law*], 148 HŌGAKUKYŌSHITSU 86 (1993). The taxonomy of rules that follows in the text is drawn from Eisenberg, at 1480–85. This basic classification is equally accurate in regard to Japan's Company Law. However, to a greater degree than U.S. state corporation statutes, the Japanese Company Law is largely mandatory in nature.

59. Directors [*torishimariyaku*] are elected to the board at the general meeting of shareholders. COMMERCIAL CODE art. 254(1). The board must consist of three members, *id.* art. 255, who serve terms of not more than two years, *id.* art. 256(1).

60. Under the Japanese Commercial Code, directors' conduct is governed by a duty of care, defined in relation to the Civil Code's mandate principles as the "care of a good manager," COMMERCIAL CODE art. 254(3); CIVIL CODE art. 644, and a duty of loyalty, COMMERCIAL CODE art. 254-3. Japanese courts and scholars disagree over whether the duties of care and loyalty are coterminous or distinct. These duties are supplemented by duties to avoid both self-dealing, COMMERCIAL CODE art. 265, and competition with the corporation, COMMERCIAL CODE art. 264. For an extensive discussion of the liability rules governing Japanese managers, see Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U. L. REV. 1436 (1994).

61. Article 267 of the Commercial Code provides for a derivative suit mechanism similar to that found in U.S. corporate law. Under Article 267, any shareholder who has held a share of the corporation's stock continuously for the preceding six months may demand that the corporation institute a lawsuit to enforce a director's liability. If the corporation accepts the demand, it takes over the suit. If the corporation does not take action within 30 days, however, the shareholder may sue derivatively on behalf of the corporation. Where irreparable damage is threatened to the corporation by the expiration of the 30-day period, the shareholder may institute the suit immediately.

62. COMMERCIAL CODE art. 232-2 (shareholder proposals).

63. *See infra* notes 69–70 and accompanying text.

64. COMMERCIAL CODE arts. 264, 265, 266 (interested director transactions).

65. The proxy rules are set out in scattered codes and ministerial ordinances. *See* SEL art. 194; Kabushiki kaisha no kansa nado ni kansuru shōhō no tokurei ni kansuru hōritsu [Law for Special Exceptions to the Commercial Code Concerning Audits, etc. of Joint Stock Companies], Law No. 22 of 1974, art. 21-2 and 21-3; Daikaisha no kabushiki sōkai no shōshutsushi ni tempusubeki sankō shorui nado ni kansuru kisoku [Regulation on Reference Documents, etc. to be Included in the Notice of Shareholder Meetings of Large Corporations], Ministry of Justice Regulation No. 27 of 1982, as amended.

66. SEL art. 1.

67. *Id.* art. 166.

the outstanding shares must give up any profits from short-swing trades, even if the trades were not based on inside information.[68] The corporation must file reports[69] containing financial data audited by an independent accountant.[70] Tender offers[71] and disclosures by shareholders owning more than five percent of the shares of public companies[72] are regulated in a manner very similar to the dictates of the United States Williams Act.[73]

This imported legal framework reflects not only the substance, but also the intellectual moorings of United States corporate and securities laws as articulated in Berle and Means' influential book *The Modern Corporation and Private Property*,[74] which has shaped U.S. corporate theory for nearly half a century.[75] Berle and Means started from the assumption of shareholder primacy implicit in U.S. corporate law,[76] incorporated property rights and democracy theory into their analysis, and concluded that the modern corporation's need for huge inputs of capital and specialized management leads to the separation of shareholder ownership from management control. The separation gives rise to an inevitable divergence of interests between shareholders and managers because the latter do not bear a major share of the wealth effects of their decisions.

At the center of this model of the corporation is the depersonalized and transient relationship between shareholders and managers.[77] Share-

68. *Id.* art. 164.

69. *Id.* art. 24 (annual reports); *id.* art. 24-5 (semiannual reports); *id.* art. 24-5(3) (extraordinary reports).

70. *Id.* art. 193-2.

71. *Id.* art. 27-2 to 27-22.

72. *Id.* art. 27-23 to 27-30.

73. 15 U.S.C. §§ 78m(d)–(e), 78n(d)–(f), 78(s) (1988).

74. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). Of course, the separation of shareholder ownership from managerial control in the Anglo-American corporate tradition long predated Berle and Means.

75. *See, e.g.*, David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 228–29 (stating that Berle and Means' vision of shareholders as "owners" of the corporation and managers as fiduciaries supplied for many decades the basic model for thinking about the corporation and corporate law); Barry D. Baysinger & Henry N. Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257, 1269 (1985) (thesis on separation of ownership and control popularized by Berle and Means in the 1930s "has dominated legal scholarship and education regarding relationships within the corporation ever since"); Douglass C. North, *Comment on Stigler and Friedland, "The Literature of Economics: The Case of Berle and Means,"* 26 J. L. & ECON. 269, 271 (1983) (stating that the academic debate on Berle and Means' book fifty years after it was written is indicative of its influence on ideological perspectives of subsequent generations).

For insightful discussions of the Berle and Means model from a comparative corporate governance perspective, see Gilson & Roe, *supra* note 16; Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 (1993).

76. Millon, *supra* note 75, at 223–24 (stating that the shareholder primacy principle has been the fundamental postulate of corporate law since Dodge v. Ford, 204 Mich. 419, 170 N.W. 668 (1919)).

77. *See* Chayes, *supra* note 3, at 40 (arguing that securities markets have rendered shareholders'

holders are tenuously bound to the modern corporation by only the weak legal rights conferred by their shares. Berle and Means argued that a share represents "a capitalized expectation,"[78] but recognized that expectations in discrete relationships often require formal mechanisms for their enforcement.[79] The authors advocated two such mechanisms: developed and orderly stock markets to provide liquidity to disgruntled investors[80] and government regulation of the relationship between managers and other corporate constituents, of which the shareholder holds the uppermost position.[81]

The separation of ownership and control thus became one of the principal notions animating United States corporate and securities laws.[82] Mitigating the agency costs resulting from the separation framed the organizational imperative of corporate governance in the United

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relation to the corporation highly abstract, formal, and readily reducible to monetary terms). In the terminology of relational contract theory, it is a "discrete" relationship.

78. BERLE & MEANS, *supra* note 74, at 321.

79. Berle and Means were not the only scholars of the era to draw a close link between depersonalized investments and the importance of enforcement mechanisms provided by the legal system. *See* Karl N. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704, 721 (1931) ("Whatever the need for legal enforcement of contract in current dealings, then, its place in an *investment* structure is obvious. It is essential to any approach to a market for capital .... [B]onds and stock ... are thought of as property ... [and] as in the nature of promises: anticipated performance by 'the corporation' (which is factually viewed as centered in the managing personnel ...) is the essence of the picture; and legal sanction in both cases looms very large.") (emphasis in the original).

80. BERLE & MEANS, *supra* note 74, at 321. ("[I]t is plain that the whole future of the present system is inextricably bound to successful functioning of the securities markets. If the apparent liquidity provided by the stock markets were eliminated, the history of industrial capitalism would probably take a new direction.").

81. *Id.* at 300–57; *see also* Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1683 (1988) (explaining that more intensive government regulation of management's relationship with owners and other constituents was justified since management no longer felt the immediate consequences of the corporation's economic decisions).

82. *See, e.g.*, H.R. Rep. No. 1383, 73d Cong., 2d Sess., 5 (1934) (discussing ill effects of divorce of management from ownership during passage of Securities Exchange Act of 1934); Louis Loss, FUNDAMENTALS OF SECURITIES REGULATION 6 (2d ed. 1988) ("The important *law-shaping* factors in recent decades have in fact been the dispersion of ownership among great masses of stockholders—who clearly do *not* control regardless of who does—and the size of modern corporate entities.") (emphasis in the original); Granada Investments v. DWG Corporation, 823 F. Supp. 448, 456–57 (N.D. Ohio 1993) (stating that the separation of ownership and control spawned efforts to regulate corporate governance and was one of the factors underlying enactment of federal securities acts); Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late*, 43 AM. U. L. REV. 379, 383–87, 401 (1994) (explaining how Berle and Means' study prompted reexamination of regulations affecting corporate governance structures and stating that Securities and Exchange Commission devised proxy rules with Berle and Means' corporate paradigm in mind). *But see* George J. Stigler & Claire Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J. L. & ECON. 237, 243–44 (1983) (although conceding existence of evidence suggesting powerful influence of *The Modern Corporation and Private Property* on passage of federal securities laws, expressing unwillingness to estimate "the long-run influence of the book upon attitudes of legislators and members of regulatory bodies toward corporations and security markets").

States.[83] As a result, the American template upon which Japan's corporate and securities laws are based is a discrete, shareholder-oriented, agency model of the corporation.[84] It is a model that calls out for *legal* enforcement of the corporate contract.[85]

B. *The Japanese Corporate Contract*

The shareholder-oriented agency model bears little resemblance, however, to the Japanese corporation as it is actually organized and monitored.[86] The Japanese firm does not pose as clearly the corporate control dilemma that so troubled Berle and Means and cast its shadow on both United States and Japanese law.[87] Consider an illustration: banks and interfirm capital transfers, not stock markets, supplied most of the capital that fueled industrial development.[88] As a result, large

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83. *See* Gilson & Roe, *supra* note 16, at 876; WILLIAMSON, ECONOMIC ORGANIZATION, *supra* note 24, at 157–58.

84. Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LIT. 1, 23 (1990) (arguing that the agency model is a "hierarchical decomposition of control" originating with the shareholders).

85. *See, e.g.*, Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507, 518–19 (1994) ("American corporations are governed by managers constrained primarily by legal relationships with the other constituencies, not by consensus among these different constituencies.") (citation omitted). As Painter points out, in such an environment, lawyers will play crucial roles as monitors of management's relations with other corporate constituencies. *Id.* at 518–43. *See also* Chayes, *supra* note 3, at 37 (explaining that public regulation has been the characteristic response of U.S. politics, government, and law to problems posed by the modern corporation since its emergence at the end of the 19th century).

Of course, extensive regulation may exacerbate the discreteness of the shareholder-manager relation. Macneil, *supra* note 23, at 493; Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89, 101–02 (1990) (arguing that agency problems in U.S. corporate governance are perhaps exacerbated by attempts to address them through the political-legislative process).

86. *See, e.g.*, TAKEO SUZUKI, KAISHAHŌ [COMPANY LAW] 153–54 (4th ed. 1993); Hideaki Kubori, *Nihon no kaisha soshiki no jittai to kōporēto gabanansu* [*The Actual Organization of the Japanese Firm and Corporate Governance*], 1050 JURISUTO 39 (1994) (survey results supporting conclusion that legally mandated corporate organs do not play effective role in corporate governance of Japanese firm).

Of course, a divergence between law and practice exists for U.S. corporations as well, and indeed, across all societies. The important point is not *that* a gap exists, but understanding *why* it exists and its implications for Japanese corporate governance.

87. An insight into the way in which the new legal rules and accompanying conceptual baggage were imported into Japan during the Occupation in the belief that (a) changing the rules would create a Japanese Berle and Means corporation and (b) such a creation was in fact desirable is the following statement of the chair of a commission studying the large family trusts known as *zaibatsu* that dominated the prewar Japanese economy: "Japanese corporation law is so lax that independent stockholders are deprived of opportunity to know what management is doing or to exercise any voice in corporate affairs . . . . If enterprises with diffused ownership are to be prevalent in Japan, protection of the small stockholders' interest . . . will be indispensable." *Quoted in* Blakemore & Yazawa, *supra* note 54, at 14.

88. *See, e.g.*, Juro Teranishi, *Loan Syndication in War-Time Japan and the Origins of the Main Bank System*, *in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 7, at 51, for an extensive discussion of prewar corporate control patterns. Until the 1930s, the *zaibatsu* relied on accumulated profits;

independent shareholders and groups of interconnected institutions, not dispersed individuals, have characterized Japanese shareholding patterns for most of its modern history. Major shareholders are thus highly personalized. At the same time, capital investment seldom represents the totality of the relationship between shareholders and the managers who concededly control the corporation even in Japan.[89] Exit from the shareholder-manager relationship is therefore constrained. Changes in corporate control, like finance, are intermediated by financial institutions rather than impersonal markets. In this setting, hostile takeover attempts are rare, and the market for corporate control does not function as a mechanism to discipline and monitor management.[90]

Consequently, the legal framework that the Berle and Means model helped to inspire is largely irrelevant in Japan.[91] Consider another illustration: shareholder-oriented corporate organs and mechanisms have traditionally played little role in the life of the Japanese firm. Shareholders, for example, have seldom sought ex post judicial enforcement of the fiduciary duties of management.[92] Independent directors, who figure prominently in the agency model of corporate governance in the United States, are rare. Instead, board membership is largely comprised of senior managers who have climbed the corporate ladder and

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firms outside the *zaibatsu* relied heavily on bank borrowing. Only newly formed groups of firms known as "new" *zaibatsu* used capital markets as a major source of outside funds. *Id.* at 52–58. As the control of families and holding companies in the old *zaibatsu* eroded under the influence of wartime bureaucrats and anti-capitalist sentiment, cross-shareholding became a more popular method of financing. *Id.* at 59–61. Cross-shareholding, of course, came to predominate in the postwar period. Thus, at no time in the formative stages of Japan's economic development was the issuance of shares to dispersed shareholders the principal means of raising capital for industry.

89. RODNEY CLARK, THE JAPANESE COMPANY 86 (1979) ("[S]hareholding is the mere expression of th[e] relationship, not the relationship itself.").

90. *See* J. Mark Ramseyer, *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L. REV. 1 (1987).

91. For an argument that corporate law is largely irrelevant in the United States, see Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990).

Agency analysis inspired by the separation of ownership and control breaks down when there are multiple classes of residual "owners." And if agency analysis is less than fully apt in such a situation, legal rules designed to mitigate agency costs address a problem that may not exist. If Japanese managers are agents, they are agents not only of shareholders, but of the other constituencies formed by the corporate contract. *See infra* notes 101–144 and accompanying text. Masahiko Aoki's view of the Japanese manager as a neutral arbiter of employees and shareholders can be seen in this light. MASAHIKO AOKI, THE CO-OPERATIVE GAME THEORY OF THE FIRM 172–96 (1984) (arguing that Japanese management is not a mere agent of shareholders; it welds shareholders and employees into an interdependent whole); *see also* Yoshiro Miwa, *Economic Effects of the Anti-Monopoly and Other Deconcentration Policies in Postwar Japan*, *in* THE JAPANESE EXPERIENCE OF ECONOMIC REFORMS 129, 147 (Juro Teranishi & Yutaka Kosai eds., 1993) (expressing doubt that there is any separation of ownership and control in Japan).

92. *See Zadankai: Kabunushi daihyō soshō no tetsuzukihōteki kentō* [*Roundtable: Examining the Procedural Aspects of Shareholder Derivative Litigation*], 1062 JURISUTO 8, 41–45 (1995) [hereinafter *Roundtable*] (table listing 50 shareholder derivative suits publicly reported from 1950 to 1994).

ex-bureaucrats who have "descended from heaven" into lucrative private sector jobs.[93] As career-long employees themselves, Japanese managers pursue employee welfare at least as vigorously as shareholder interests. Regulations governing takeovers and proxies lie mostly dormant on the statute books. The corporate legal framework has been employed in aid of corporate monitoring principally through the enforcement of criminal actions in a relatively small number of high profile cases.[94] Enforcement of the securities laws by regulators has traditionally been lax and informal; enforcement by private parties is virtually nonexistent.[95] Not surprisingly, licensed attorneys specializing in corporate law number in the hundreds, not the hundreds of thousands.[96]

The institutions of Japanese economic life account for the irrelevance of the Berle and Means model and those parts of Japan's legal system it helped to inspire.[97] In the highly relational environment in which the Japanese firm exists,[98] the conduct of business has traditionally neither relied upon nor generated as much formal law as in the United States. Indeed, given the disincentives to both private litigation and formal challenge to regulatory authority in Japan, a premium is placed on *avoidance* of law and legal institutions.

This section of the Article styles Japanese corporate governance as a complex of relationships embedded in the larger socio-political order. Strong institutions characterized by highly relational interaction form the key constraints: main banks, *keiretsu* corporate groups, enduring firm-specific employment patterns, and bureaucratic oversight. The

93. Actual corporate decisions devolve to a subset of the board known as the *jōmukai*, with little oversight by the full board.

94. *See* Kenjiro Egashira, *Kōporēto gabanansu wo ronzuru igi* [*The Significance of the Corporate Governance Debate*], 1364 SHŌJI HŌMU 2, 4 (1994).

95. *See* Curtis J. Milhaupt, *Managing the Market: The Ministry of Finance and Securities Regulation in Japan*, 30 STAN. J. INT'L L. 423, 454–60 (1994).

96. Numerous commentators have analyzed the Japanese and U.S. bars in an attempt to explain the yawning gap between the number of lawyers in the two countries. Many of these analyses focus on organizational factors, including differences in legal education, professional examination and training, and the existence of law-trained lawyer substitutes in Japan. *See, e.g.*, Richard S. Miller, *Apples vs. Persimmons—Let's Stop Drawing Inappropriate Comparisons Between the Legal Professions in Japan and the United States*, 17 VICTORIA U. WELLINGTON L. REV. 201 (1987). A more theoretically satisfying explanation may actually lie in the different functions that lawyers play in societies at opposite ends of the discrete-relational spectrum in their approach to business dealings and political governance. *See, e.g.*, Robert B. Thompson, *Value Creation by Lawyers Within Relational Contracts and in Noisy Environments*, 74 OR. L. REV. 315 (1995).

97. For an interesting Japanese perspective on the relationship between the Company Law and the actual system of corporate monitoring that has evolved in Japan, see Misao Tatsuta, *Kōporēto gabanansu to kaishahō* [*Corporate Governance and the Company Law*], 1364 SHŌJI HŌMU 29, 33 (1994) (arguing that legislators did not foresee a corporation monitored by banks and employees; flexibility of Japanese law permitted a fundamental transformation away from the shareholder-centered code).

98. *See infra* notes 101–144 and accompanying text.

result is a complex system of multiple constraints[99] that overcomes weak equity monitoring through strong bank, interfirm, employee, and administrative monitoring. In this light, Japanese corporate governance can be viewed as a highly developed and effective species of what Professor John Coffee calls "quasi-private ordering" or "quality-controlled" opting out.[100] The Japanese firm has opted out of the shareholder-centered statutory provisions of the corporate and securities laws, but the actions of key actors are monitored and opportunism is limited by the interactions described below.

1. Main Bank Relations

A central institution in Japanese corporate governance is the main bank system. In stylized form, the main bank is the largest single lender to a corporate client as well as one of its principal shareholders. As a central repository of information on the borrower, the main bank plays an important role in monitoring the firm's management and rendering assistance in case of managerial crisis or financial failure.[101] There is a strong presumption on the part of the main bank, the client, and of all relevant business and governmental actors that the main bank will restructure or merge a failing company rather than liquidate it.[102] Because management is often replaced by bank personnel in such situations, the main bank system is said to substitute for the missing takeover market in Japan.[103]

Three key functions are supported by the relationship between a borrower and its main bank: financing, monitoring, and information and management support. Each function is multidimensional, and the importance of any given function varies across relationships and with the financial state of the firm at a given time.[104] As a leading commentary indicates, the "central ideal of main bank relations" is that they are "multi-faceted and . . . implicitly defin[e] a wealth-contingent corporate governance system."[105]

99. *See* Tadao Kagono, *Nihonteki kaisha seido wo kangaeru* [*Considering the Japanese Company System*], ZEIKEITSŪSHIN, Nov. 1991, at 14, 17–18.

100. John C. Coffee, Jr., *No Exit, Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 972 (1988).

101. Literature on the main bank is voluminous. *See, e.g.*, THE JAPANESE MAIN BANK SYSTEM, *supra* note 7; Paul Sheard, *supra* note 19; Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAVIOR & ORG. 399 (1989) [hereinafter Sheard, *Corporate Monitoring*].

102. Hugh Patrick, *The Relevance of Japanese Finance and its Main Bank System*, *in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 7, at 353, 359.

103. Sheard, *Corporate Monitoring*, *supra* note 101.

104. *See* Masahiko Aoki et al., *The Japanese Main Bank System: An Introductory Overview*, *in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 7, at 3.

105. *Id.* at 7.

The main bank provides financing by serving as both lender and shareholder. This dual status lessens the conflicts of interest typically present between providers of debt and equity.[106] The main bank also supports public finance by playing an important role in domestic and international bond issues. It serves as the legally required collateral trustee for domestic bond issues, and frequently serves as co-manager of foreign bond issues through wholly owned foreign subsidiaries. These services often entail de facto status as guarantor of the bonds.[107] Though not strictly a financing function, the main bank typically also manages the payment settlement account of client firms, through which firms handle routine cash flow transactions.[108]

As the largest lender to the borrowing firm as well as manager of its payment settlement account, the main bank accumulates a substantial base of information on the borrower's business and financial health. The monitoring function of the main bank-borrower relationship is highly state dependent. If the borrower is experiencing no financial difficulty, the main bank engages only in ex ante and interim monitoring, by assessing proposed and ongoing projects. If the firm becomes financially distressed, however, the main bank may engage in ex post monitoring by displacing management, arranging an acquisition of the firm, or acting as an informal chair of the creditor's committee. This activity is commonly referred to as a firm "rescue," although it is actually closer to a restructuring, often involving substantial reconfigu-

106. *See* Stephen D. Prowse, *Institutional Investment Patterns and Corporate Financial Behavior in the United States and Japan*, 27 J. FIN. ECON. 43 (1990) (demonstrating that shareholding patterns by Japanese financial institutions lessen agency costs between shareholders and debtholders).

107. The function of trustee banks is to ensure the liquidation value of collateral for secured bonds. Rather than subjecting themselves to the wishes of creditors' committees, trustee banks have historically purchased the bonds of bankrupt issuers. Although they do not always get full repayment for the bonds when the value of the collateral is below the outstanding amount of bonds, this practice is the accepted norm. MOODY'S INVESTOR SERVICES, INC., CHANGING PERSPECTIVES: JAPANESE INSTITUTIONAL INVESTORS AND CREDIT RISKS OF JAPANESE COMPANIES 1–3 (1993). In all 11 corporate bond defaults between 1945 and 1990, the bonds were repurchased by the trustee bank, even though they were not legally obligated to do so. John Y. Campbell & Yasushi Hamao, *Changing Patterns of Corporate Financing and the Main Bank System in Japan*, THE JAPANESE MAIN BANK SYSTEM, *supra* note 7, at 325, 342.

This points up an interesting distinction that highlights the impact of history and politics on governance mechanisms. The U.S. market has chosen a fully specified contract in favor of an open promise by the issuer or the indenture trustee to compensate bondholders if corporate action causes them losses. William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CINN. L. REV. 385, 389 (1990). By contrast, the Japanese bondholder in effect gets a "poison put" to return the bond to the bank at par. The banks agree to this occasionally disadvantageous risk-shifting in return for their lucrative, legally mandated status as keepers of the collateral. Major banks encouraged adoption of collateral requirements in the 1930s and blocked the rise of credit rating agencies that could have diminished the importance of secured bond issues. *See* Kazumasa Niimi, *An Analysis of Bond Rating in Japan: Its History, Status, and Future*, JAPAN RES. Q. 35 (1992).

108. Aoki et al., *supra* note 104, at 14–15.

ration of the business, including replacement of management and significant concessions by labor and suppliers.[109]

The main bank also provides a range of services to its clients that in other economies would be performed by investment banks, venture capitalists, and credit rating agencies. For example, it renders advice and matchmaking services on mergers and acquisitions, real estate transactions, and other corporate projects. The main bank also performs a signaling function analogous to that of a credit rating agency, as prospective creditors rely on the main bank's superior information in determining whether to extend credit to a particular firm.[110]

The main bank system performs these functions by integrating the traditional debtor-creditor relationship into a larger "nexus of relationships" involving other banks and the regulatory authorities.[111] Through reciprocal arrangements among major banks, the main bank serves as the delegated monitor of its client firm.[112] In informal workout scenarios, the main bank will typically absorb a larger share of the losses than would be strictly required in proportion to its share of the loan. Although the main bank almost always has a first priority interest in the collateral of the debtor, the main bank in effect voluntarily subordinates its interest to that of the other lenders.[113] This allows the main bank to take control of the workout, which is efficient because the main bank's position allows it to acquire information on a less costly basis than other lenders and prospective managers of the failing business. It also diminishes the moral hazard that the main bank will shirk its ex ante and interim monitoring duties in reliance on its first priority interest.[114] The main bank is believed to perform this role because it will free ride on the monitoring efforts of other banks when it lends as a non-monitoring bank.[115]

At the top of this monitoring pyramid stands the ongoing, reciprocal relationships between the banks and the financial authorities. In return for implicit guarantees of financial stability, the banks are sometimes pressured by financial authorities to engage in ex post

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109. For an in-depth account of one such restructuring, see Richard Pascale & Thomas P. Rohlen, *The Mazda Turnaround*, 9 J. JAPANESE STUD. 219 (1983). For a survey of numerous cases, see Paul Sheard, *Main Banks and the Governance of Financial Distress*, *in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 7, at 188, 213–26.

110. James E. Hodder & Adrian E. Tschoegl, *Corporate Finance in Japan*, *in* JAPANESE CAPITAL MARKETS: NEW DEVELOPMENTS IN REGULATIONS AND INSTITUTIONS 133, 140 (Shinji Takagi ed., 1993).

111. For an extensive account of the main bank system as a "nexus of relationships," see Aoki et al., *supra* note 104.

112. Sheard, *supra* note 19.

113. Kazuhito Ikeo, *Tenki mukaeta "nihongata shori mekanizumu"* [*The "Japanese Disposition Mechanism" in Transition*], EKONOMISUTO, Nov. 8, 1993, at 56.

114. *Id.*

115. *See* Sheard, *supra* note 19, at 15.

monitoring that they would otherwise avoid.[116] But because the authorities are themselves dependent upon the banks for information, regulatory expertise, and post-government careers, the banks maintain a significant check on bureaucratic opportunism.[117]

2. Inter-Corporate Relations

A second prominent feature of corporate finance and organization in Japan is the practice of mutual shareholding among firms and financial institutions. Approximately two-thirds of all corporate shares are held long term by "stable" shareholders friendly toward management.[118] This practice reaches its apex in the form of the *keiretsu*. The *keiretsu* are historically derived clusters of affiliated firms held together by stable cross-share ownership, interlocking directorates, extensive product market exchanges, and other linkages that enhance group identity and facilitate information exchange. A main bank is at the center of each of the six principal *keiretsu* corporate groups.

The *keiretsu* system and other, less cohesive corporate groupings are a means of encouraging asset-specific investments and product-market competition, thus constraining both opportunism and shirking.[119] Although cross-shareholding raises the cost of acquiring a controlling block of shares, thus virtually disabling the market for corporate control,[120] the long-term relationships embedded in Japanese corporate shareholding, which are based on ongoing financial and product-market transactions, encourage non-capital market forms of monitoring. These relationships, in effect, provide an alternative to the disciplining and risk-bearing functions played by the capital markets in some other economies.[121] From its origin as an anti-takeover device, cross-shareholding in Japan has thus evolved into a distinctive private monitoring and bonding mechanism.[122]

Intense inter-group competition in product and labor markets, in turn, prevents the group system from degenerating into an exercise in

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116. Pascale & Rohlen, *supra* note 109, at 233 (arguing that the Japanese government leverages a commitment to stability by encouraging private-sector institutions to assume responsibility); Sheard, *supra* note 19, at 17–18.

117. For further elaboration on public-private sector relations in Japanese corporate governance, see *infra* notes 133–144 and accompanying text.

118. *See* KEIZAI HAKUSHO [WHITE PAPER ON THE ECONOMY] 231 (Keizai kikakuchō ed., 1992).

119. For a highly developed argument to this effect, see Gilson & Roe, *supra* note 16.

120. Ramseyer, *supra* note 90, at 46.

121. Paul Sheard, *Japanese Corporate Finance and Behavior: Recent Developments and the Impact of Deregulation*, *in* JAPANESE FINANCIAL MARKETS AND THE ROLE OF THE YEN 55, 60–63, 66 (Colin McKenzie & Michael Stutchbury eds., 1992).

122. Kunio Itō, *M&A to kabushiki mochiai no honshitsu* [*M&A and the Essence of Cross-Shareholding*], KIN'YŪ JĀNARU, Dec. 1989, at 11.

mutual shirking. High market prices and substantial firm-specific investments by suppliers and dealers linked to particular corporate groups help to explain why Japanese products have maintained quality standards among the highest in the world, largely without contractual protections for parts purchasers or the threat of substantial product liability.[123]

3. Employment Relations

Concern for the long-term welfare of employees serves as a major constraint on the Japanese firm. Under the "lifetime" employment system, the mutual expectation of employer and employee is that the employee will trade below-market wages in the first half of his or her career in return for an implicit promise of continuous employment until mandatory retirement age[124] and supra-market wages in the second half of his or her career.[125] Employees within the system receive extensive training and education in a program of systematic job rotation and promotion.[126] Because labor mobility is limited and the employee has in effect posted a bond at the outset of the employment relationship that will only be fully recouped upon retirement, employees have a significant vested interest in the continued viability of their firm.

While there is typically no written agreement to safeguard the employee's interests, a number of extra-legal protections provide substantial assurances that the employer will not opportunistically appropriate the gains generated by the employee's substantial firm-specific human capital investment.[127] First, since high-level corporate management is drawn from the ranks of career employees, managers are themselves long-term repeat players who realize that employee goodwill is crucial to the success of the business and who identify very closely with employees.[128] Japanese managers rate market share, which

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123. Even without resort to law enforced by the state, cheating will be prevented and high quality products will be supplied if firms earn a continual stream of income that will be lost if low quality output is deceptively produced. Market prices above the competitive price and the presence of nonsalvageable capital are means of enforcing quality promises. Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981). On Japan's traditionally limited product liability system, see *infra* notes 310–312 and accompanying text.

124. Mandatory retirement age is currently 60 in most companies.

125. Compensation, however, is not only monetary, but also typically includes subsidized housing, medical care, company-sponsored recreation, and similar benefits.

126. Kazuo Sugeno, *The Structure of Industrial Relations in Japan*, *in* JAPANESE COMMERCIAL LAW IN AN ERA OF INTERNATIONALIZATION 275, 276 (Hiroshi Oda ed., 1994).

127. There are, to be sure, legal protections for workers as well. For a discussion of the protections provided by the courts, see *infra* notes 213–217 and accompanying text.

128. *See* Carney, *supra* note 107, at 407.

is closely tied to employee welfare, ahead of more shareholder-oriented goals.[129] Since the market for managerial talent is similarly limited and managers also make large firm-specific human capital investments, management is prone to emphasize growth as a means of diversifying risk. High rates of growth in the postwar period have allowed Japanese firms to operate heavily on trust because it is cheaper than reliance on explicit contracts.[130]

The corporate culture[131] in which the Japanese firm operates provides a second protection. Ex ante, the cost of writing an explicit contract to cover all the uncertainties inherent in an employment relationship of thirty or more years is prohibitive and makes such contracts rare. Moreover, the individual employee has virtually no power to control the ways in which the firm will adapt to unforeseen contingencies over the course of his or her career. Corporations are, however, reputation-bearing entities; a firm's favorable reputation provides prospective employees with the confidence to enter into a highly enduring and unspecified relationship with an employer. Corporate culture communicates to potential employees an important principle about how the firm responds to uncertainties. The organization will be characterized by the principle that it selects and articulates to the world in the form of its corporate culture. At the same time, the continuous articulation of the rule in the form of reputation allows the firm to monitor the principle. In this way, corporate culture serves as an important gap-filling and monitoring device to economize on transaction costs in complex environments.

From a corporate culture perspective, it is clear why Japanese firms are so reluctant to lay off employees. No firm wants to tarnish its corporate culture by signaling to future generations of potential employees that it will respond unfavorably to workers in times of financial distress, particularly in an illiquid labor market where virtually all intake occurs through the hiring of university graduates.[132] The one-time gains from appropriating the bonds of current workers to relieve financial difficulties would be more than offset by losses in the future stream of talented and enthusiastic employees.

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129. JAMES C. ABEGGLEN & GEORGE STALK, JR., KAISHA: THE JAPANESE CORPORATION 176–77 (1985).

130. Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297, 301 (1978).

131. The seminal discussion of corporate culture in economic perspective is Kreps, *supra* note 3. The discussion in text is drawn from Kreps.

132. Foreign firms in Japan have learned this lesson the hard way. *See Japan's Top College Grads Thumb their Noses at Foreign Firms*, TOKYO BUSINESS TODAY, May 1993, at 6, *available in* LEXIS, ASIAPC Library, ALLASI File (explaining how personnel reduction policies at foreign firms solidify their image among Japanese as unreliable, making recruitment difficult).

Finally, employees are protected from a form of employer opportunism that is possible in a stock-market oriented governance system—appropriation of employee human capital investments in takeover contexts. Whether or not appropriation of this sort actually occurs may be irrelevant. If employees believe that it occurs, the belief would be sufficient to deter some human capital investments. In a world without hostile takeovers such as exists in Japan, one major source of potential employer opportunism is removed and employee commitment to the firm is enhanced.

4. Government-Business Relations

As the discussion of main bank relations suggests, government-business relations are a crucial facet of the Japanese corporate contract. In the abstract, interaction between the public and private sectors can be viewed in relational perspective.[133] Detailed, binding regulations promulgated by bureaucracies are highly discrete.[134] By proscribing detailed rules, procedures, and formal mechanisms, regulation typically is an attempt to carve economic and other activity into distinct regulatory universes, to treat each case separately "on the merits," and to allocate benefits and burdens ex ante. In other words, most regulation serves as a discrete contract between the regulators and the regulated.

The vast majority of regulatory activity in Japan, however, is the antithesis of discrete contract. Private ordering facilitated by repeated, informal contacts between regulators and the regulated acts as the key element in forming and enforcing economic policy in Japan. As the lexicon invented to describe this approach suggests,[135] the bureaucracy is seen as engaged in an ongoing process of accommodation with regulated actors, shaping and enforcing compromises rather than directing policy outcomes. As Professor Frank Upham notes, the "consultative consensual character" of the Japanese administrative process, with its exclusion of outsiders and insulation from legal attack, "create[s] an environment in which good relations are the key to success

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133. *See* IAN R. MACNEIL, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS 124 n.39 (1980).

134. *Id.* at 77 ("[T]he greatest blossoming of discreteness and presentiation the world has ever seen is . . . to be found . . . in the detailed rules of bureaucracies . . . . The significance of this for relational contract law is immense.").

135. *See, e.g.*, JOHN O. HALEY, AUTHORITY WITHOUT POWER: LAW AND THE JAPANESE PARADOX 144 (1991) ("consensual administrative management"); RICHARD J. SAMUELS, THE BUSINESS OF THE JAPANESE STATE: ENERGY MARKETS IN COMPARATIVE AND HISTORICAL PERSPECTIVE 260 (1987) ("reciprocal consent"); FRANK K. UPHAM, LAW AND SOCIAL CHANGE IN POSTWAR JAPAN 226 (1987) ("informal policymaking" through compromise, consultation, and concessions that rely on mutual trust); Michael K. Young, *Administrative Guidance and Industrial Policy: Participatory Policy Formation and Execution in Japan, in* EIBEIHŌ RONSHŪ 569, 578 (Kōichirō Fujikura ed., 1987) ("governmentally encouraged and structured private ordering").

in dealing with the government . . . . The end result is a relationship of diffuse and undefined mutual obligations . . . ."[136]

Administrative guidance is a crucial facilitating mechanism in this private ordering process. Long shrouded in mystery, administrative guidance is simply the informal enforcement of regulatory objectives.[137] While the technique is not unique to Japan, it has attracted particular attention because it is *the* principal regulatory technique among Japanese regulators. Administrative guidance is the glue that holds together repeated dealings between the public and private sectors in Japan. The ability of the regulated to participate in the regulatory process outweighs the disadvantages of occasional bureaucratic strong-arm tactics; the flexibility and discretion it affords the regulators vastly surpass the costs of reliance on such informal means to achieve administrative ends. Administrative guidance also protects these repeated dealings from internal and external legal challenges that, if successful, would particularize and rigidify the business-government relationship.

Administrative guidance is also highly efficient from the perspective of contracting costs. In a rapidly growing postwar Japanese economy, the demand for regulation expanded more quickly than regulators were equipped to handle.[138] It was less costly to use the flexible, implicit contract of legally unenforceable administrative guidance over legislation and formal regulation.[139] Securing voluntary compliance with ministry guidance saves the agencies considerable administrative and political costs that would otherwise be incurred in proposing and amending laws in the Diet. At the same time, regulated entities obtain official approval for their activities flexibly and expeditiously in the face of a rapidly evolving business environment.

Private ordering is further facilitated by the practice of *amakudari*, in which bureaucrats take high-level private sector jobs at the end of their public careers. These ex-bureaucrats become board members and high-level managers of their new host firms and provide critical access to the agencies with jurisdiction over their industry.[140] Since *amakudari* gives bureaucrats a personal stake in not alienating the corporate sector under their jurisdiction, it helps to ensure that the government will

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136. UPHAM, *supra* note 135, at 203–04.

137. HALEY, *supra* note 135, at 162.

138. *See The American Role Model*, ECONOMIST, July 9, 1994, at 17 (Japanese "[b]ureaucrats could not enact regulations appropriate to an economy that was changing by the day. So they invented a more flexible tool: administrative guidance.").

139. *Cf.* Klein et al., *supra* note 130, at 318.

140. *See* Kent E. Calder, *Elites in an Equalizing Role: Ex-Bureaucrats as Coordinators and Intermediaries in the Japanese Government-Business Relationship*, 21 COMP. POL. 379 (1989) (arguing that *amakudari* performs an equalizing role, as ex-bureaucrats provide regulatory benefits, information, and insurance against adverse government action to the smaller firms where they disproportionately land).

not unilaterally rewrite the regulatory contract.[141] Not surprisingly, the most heavily regulated industries, such as finance and construction, take in the most retired bureaucrats.[142]

Administrative guidance and *amakudari* profoundly influence the boundaries of the Japanese firm. Literally and figuratively, these practices place bureaucrats within the Japanese firm.[143] As the following brief case study shows, the very concepts of "business judgment" and "corporate governance" require reexamination in an economy with extensive public-private cooperation and pervasive long-term corporate interaction.[144]

C. Relational Governance and Legal Informality: An Illustration

The Japanese securities industry exemplifies the way extensive, long-term cooperation affects the operation of an industry, the frequency of resort to legal institutions, and the development of law.

Five institutions form the core of the Japanese securities industry: the "Big Four" securities firms, which gained ascendance as the underwriters to newly formed industrial groups in the 1940s and never relinquished their superiority, and the Ministry of Finance (MOF), which regulates all aspects of public and private finance and maintains a tight-fisted grip on a licensing system for new entrants into the securities industry.[145] With their virtual lock on the underwriting business, the Big Four are the masons that erected the extensive network of postwar cross-shareholdings that form the *keiretsu* and other less cohesive corporate groups, blocking the growth of discrete shareholding patterns. As such, they maintain a vast reservoir of information on their corporate clients, which fortifies their extensive client relation-

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141. *Cf. id.* at 379–80 (examining *amakudari* as a means to influence government "and thus to reduce risk to the firm created by unpredictabilities of state regulatory policy").

142. Fumitoshi Takahashi, *Kaisha to kanchō [The Firm and the Bureaucracy]*, 1050 JURISUTO 50 (1994); *see also* NIHON KEIZAI SHIMBUN, Dec. 7, 1993, at 7 (survey results indicating that *amakudari* is supported most strongly by managers in highly regulated industries; managers in less heavily regulated industries consider the practice to be unnecessary).

143. Extensive bureaucratic involvement in corporate control finds its historical antecedents in the wartime economy. *See* Teranishi, *supra* note 88, at 52 (arguing that, beginning in 1940, corporate managers were increasingly placed under the control of planning-oriented bureaucrats, who played a prominent role in corporate monitoring).

144. One commentator, citing the Ministry of Finance's financial regulation as a prime example, argues that corporate governance in the true sense has never developed in Japan, because extensive bureaucratic involvement in industry overrides management responsibility for corporate conduct. *See* Takahashi, *supra* note 142, at 50–51. *See also* Juro Teranishi, *Financial Sector Reforms After the War*, in THE JAPANESE EXPERIENCE OF ECONOMIC REFORMS, *supra* note 91, at 153 (asserting that postwar reforms shifted corporate control in the financial sector largely to the bureaucrats).

145. Prior to 1993, when a limited number of bank affiliates were allowed to enter the securities business, no new securities companies had been licensed by MOF since the establishment of the licensing system in 1965.

ships. MOF's Securities Bureau, which was traditionally understaffed and subordinate to the more prestigious and powerful Banking Bureau, has utilized the information and expertise of the Big Four in its regulation of the capital markets. In return, the major firms have enjoyed limited competition and extensive participation in the regulatory process.[146]

The impact of this environment on law is highly revealing. First, the shareholding structure of Japanese corporations works to limit securities litigation. Because stable equity-holding relationships typically cement business ties, securities litigation is unnecessary or even counterproductive in securing a company's primary interests. Because the market for corporate control in Japan is intermediated by stable, friendly shareholders, strategic use of securities litigation in acquisition contexts is virtually nonexistent. Thus, securities law violations traditionally have not been pursued aggressively by investors, and few Japanese attorneys have found it worthwhile to develop an expertise in civil liability under the securities laws. As a result, over the postwar period, the securities laws have essentially atrophied for lack of enforcement.

Moreover, litigation against MOF in connection with its administration of the securities laws is virtually nonexistent. The reason lies in the process through which legislation and administrative rules are formulated and enforced in Japan. Policy questions and specialized administrative issues are considered by advisory councils [*shingikai*] composed of selected representatives from business, academia, and other sectors of society. Industry participants virtually never challenge regulations formulated through this process, both because they participate in formulating the regulations, and because a challenge would jeopardize their crucial relationship with the regulatory agency.[147] Maintaining this long-term relationship is of far greater importance than invalidating any single offensive regulation or policy. Most importantly, though, since much regulatory enforcement is informal, a legal challenge is difficult. Thus, parties outside the regulatory process who may have incentives to sue are effectively prevented from legally challenging governmental conduct.

This type of ex ante monitoring system for securities activities, in which selected parties reach a consensus on a legal norm for a particular activity and then seldom resort to ex post settling-up mechanisms, typifies the Japanese approach to regulation.[148] It stands in stark con-

146. For an extensive discussion of Japanese securities regulation, see Milhaupt, *supra* note 95.

147. *See* Michael K. Young, *Judicial Review of Administrative Guidance: Governmentally Encouraged Consensual Dispute Resolution in Japan*, 84 COLUM. L. REV. 923, 934–41 (1984).

148. For a more extensive analysis of this process and its impact on securities regulation, see

trast to the emphasis on ex post monitoring through litigation of regulatory and market activities in the United States.[149] By limiting the number of participants in the securities industry, MOF's miserly administration of the licensing system helps facilitate a consultative process. Ex ante monitoring, in turn, de-emphasizes formal enforcement and monitoring by encouraging informal, preventive regulation and by restricting participation in the policy-making process to parties represented in the *shingikai.*

A highly publicized derivative suit against Nomura Securities Co.,[150] the biggest of the Big Four, and the circumstances that gave rise to it demonstrate both the importance of long-term relationships in industry and the effect of cooperative regulation on the development of law in Japan. In 1991, a Nomura shareholder brought a derivative suit against the company's president and other directors seeking 100 million yen (about $1 million) in damages for payments made by Nomura to one of its biggest clients. The payments were rebates for trading losses sustained by the client in a discretionary trust account after the Tokyo stock market began falling precipitously in 1989. Similar payments totaling the yen equivalent of almost $2 billion by major securities firms had ignited a major financial scandal in the preceding months. The shareholder argued that the payment of compensation for losses was a breach of the directors' duties of care and loyalty, as well as a violation of the securities laws and the Anti-Monopoly Law.

The payment of compensation, the reaction of the regulators, and the court's decision all provide important commentary on relational governance in Japan. No firm, of course, likes to alienate major clients. But given the regulatory structure of the Japanese financial industry, maintaining long-term relationships with large companies is crucial to the business practices of the Big Four.[151] Thus, the firms paid out vast amounts of loss compensation even after they were prohibited from doing so by MOF.[152] MOF, however, took no discernible action against

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Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 U. PA. J. INT'L BUS. L. 569 (1991).

149. Litt et al., *supra* note 19, at 430–46.

150. Judgment of Sept. 16, 1993 (Ikenaka v. Tabuchi, or The Nomura Case), Tokyo Chisai [Tokyo District Court], 1469 HANJI 25.

151. Historical constraints on securities finance, see *infra* notes 171–175 and accompanying text, led to heavy reliance on brokerage commissions as the major source of securities firm profits. For the largest firms, these profits were markedly enhanced by the regulation of commissions, which were set at levels designed to keep small firms in business. Underwriting business, which is dispensed principally by the largest corporations, is highly coveted work because it provides entrance into the corporate network of the issuer and enhances the underwriter's stature in the industry, both of which lead to increased brokerage business. This explains why compensation was paid only to the largest clients, mainly by the major securities firms with active underwriting departments.

152. In December of 1989, the Securities Bureau of the Ministry of Finance advised securities

the firms until disclosure of the payments created a groundswell of public condemnation. MOF was initially unresponsive to clear violations of its directives because informal guidance was its favored response to industry problems and because formal sanctions would have exposed systemic defects in its cooperative financial regulatory scheme, such as a lack of price competition in the industry.

The Tokyo District Court's decision highlights both the importance of long-term relations in business and the confounding influence of intensive public-private interaction on law. The court held that the business judgment rule shielded the directors' decision to pay compensation, accepting the defendants' argument that payment of compensation was essential to the maintenance of good relations with major clients.[153] The court was unable to find that payment of compensation was prohibited by the securities laws at the time, in spite of MOF's explicit directive to that effect. In so holding, it is plausible to see the court recognizing that MOF's close interaction with the large securities firms blurred the lines of lawful conduct and implicitly signaled that the ministry condoned the firms' payments. Ambiguous securities laws have also obscured the scope of the directors' fiduciary duties to the shareholders, making it difficult to base director liability on a legal violation.[154] Given the ambiguity of the legal environment, the court could not fairly hold the directors liable to the shareholders, particularly when the conduct was designed to preserve economically valuable relations with major customers.[155]

Nomura also illustrates how relational governance constrained the development of corporate law in Japan. The decision is important for its clear statement of the business judgment rule.[156] Due to a lack of

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companies in a circular notice that a popular type of discretionary trust account should be closed, and that payment of compensation to clients who sustained trading losses was prohibited. The securities laws explicitly prohibited the advance guarantee of such compensation, but were silent on payment of compensation ex post. The securities companies ignored the directive, paying out over 83 billion yen in loss compensation to their customers following the issuance of the circular. *Kinshi tsūtatsugo 828 oku-en* [*82.8 Billion Yen after the Prohibition Circular*], NIHON KEIZAI SHIMBUN, Aug. 21, 1991, at 5.

153. *Nomura*, 1469 HANJI at 29–30.

154. *See* Hideki Kanda, *Kabunushi daihyō soshō ni kansuru rironteki sokumen* [*Theoretical Aspects of Shareholders Derivative Suits*], 1038 JURISUTO 65 (1994). In recognition of the shareholder's position, the court held that loss compensation violated the Anti-Monopoly Law as an unfair means of soliciting customers. Yet it found that no damage was inflicted on the corporation by the violation, since Nomura benefited from strengthened business ties. In dicta, the court condemned the payment of loss compensation for its damaging influence on the fairness, and the public perception of the fairness, of the stock markets. *Nomura*, 1469 HANJI at 32.

155. Given the facts, the court's holding is perhaps unsurprising to a U.S. reader. Yet the indeterminacy of the fairly basic legal rules at issue and the regulator's lack of enforcement efforts despite virtual disregard of its directives by an industry under its jurisdiction contrast starkly with the U.S. environment for securities regulation.

156. In its formulation of the business judgment rule, the court enunciated a standard close

derivative litigation conducted in the past, the business judgment rule is not well established in Japanese corporate law.[157] Japanese courts have not articulated a general rule shielding director conduct from judicial scrutiny.[158] Similarly, the scope and content of a director's legal duties remain obscure. In the wake of a recent rash of derivative litigation, of which *Nomura* is a high profile example, Japanese management has become concerned with ways to limit the scope of liability rules. Yet there is no express legal framework in the Commercial Code for mechanisms such as exculpatory provisions in corporate charters, indemnification, and director and officer liability insurance that corporate boards in the United States use to opt out of liability rules.[159] Moreover, there is no legal authority for the creation of special litigation committees, which are the standard mechanism for terminating derivative litigation in the United States. By contrast, the Commercial Code provides for only a limited response by the board of directors to derivative suits.[160] The early stage of development of Japanese law in this area is a clear reflection of the fact that until very recently, a multidimensional system of relational governance dramatically reduced the resort to shareholder-oriented ex post enforcement mechanisms and restrained the growth of Japanese corporate and securities laws.

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to the "gross negligence" formulation of the rule applied in some U.S. jurisdictions. The court stated that

> it is not sufficient for a finding of breach of duty that a director's business judgment resulted in a loss to the corporation .... Rather, the court, focusing on the business decision actually made by the director, should inquire whether there was a careless misunderstanding of the factual basis for the business decision and whether the decision-making process based on those facts was markedly irrational for an average corporate employee. If so, the director's business decision is removed from the permitted scope of discretion, and a finding that the director has breached his duty of care and loyalty is appropriate.

Nomura, 1469 HANJI at 30.

157. HIDEAKI KUBORI & NAOTO NAKAMURA, KABUNUSHI DAIHYŌSOSHŌ TO YAKUIN NO SEKININ [SHAREHOLDER DERIVATIVE SUITS AND DIRECTOR AND OFFICER LIABILITY] 114 (1993). One potential benefit of shareholder derivative litigation is that judicial decisions clarify the scope of permissible conduct of managers. Clarification both deters managerial misconduct and identifies a rule around which managers and shareholders can transact in the future. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991).

158. KUBORI & NAKAMURA, *supra* note 157, at 114–21.

159. *See, e.g.*, 8 DEL. CODE § 102(7) (permitting provision in certificate of incorporation limiting or eliminating personal liability for directors for certain breaches of duty), § 145(f) (permitting indemnification by bylaw, agreement, vote of stockholders or disinterested directors, or otherwise), and § 145(g) (permitting the corporation to purchase insurance for directors). The Commercial Code does provide for ex post release of a director's liability for a specific act upon the unanimous vote of shareholders. COMMERCIAL CODE art. 266(5).

160. Once the board of a Japanese firm has received a shareholder's demand, the sole means of wresting control of the litigation from the shareholder is to institute the suit. Refusing demand simply allows the shareholder to proceed with the derivative suit. Directors have but two blunt instruments with which to deter litigation they deem to be unwarranted: security for expenses provisions in the Commercial Code and the "abuse of rights" doctrine, which can be invoked to pursue a damage award if a derivative suit is brought in bad faith for harassment purposes.

III. LAW'S EFFECT ON RELATIONSHIPS: EXIT, VOICE, AND LOYALTY[161] IN THE JAPANESE CONTEXT

A. Introduction

As Part II demonstrates, a study of Japanese corporate governance quickly confronts two striking phenomena: the formal legal regime appears to have little influence in shaping the most important institutions in economic life, and enforcement within these institutions appears to be entirely informal. Not surprisingly, many commentators focusing exclusively on these phenomena conclude that law is all but irrelevant in the nexus of constraints on the Japanese firm. Closer analysis, however, reveals a major role for law.

Part III brings the significance of the Japanese legal system into focus by examining the state's contribution to the environment in which the extensive private ordering described in Part II takes place. The focus in this part is on law as a framework for ongoing relationships.[162] Just as a highly relational environment affects law, law plays a crucial role in setting the framework for cooperation. Law, as one commentator puts it, "provides for the accomplishment of cooperation."[163] Law can also coerce interdependence by erecting barriers to exit from relationships. It authoritatively articulates accepted norms of conduct that emerge from repeated interaction, and punishes those who deviate from such norms. In its broadest form, law provides the setting for all exchange; the state plays a role in every relationship.[164]

This perspective illuminates both the pervasiveness and the effectiveness of law in shaping the nexus of corporate constraints in Japan. Strong bank, governmental, and employee monitoring are supported by powerful legal norms. Much of the long-term cooperation described in Part II is a function of statutory and judicial rules that block exit while encouraging loyalty and flexibility in ongoing relations. The key

161. Albert Hirschman identified exit and voice as the two basic means of self help available to a member of an organization that is moving in a direction perceived as undesirable. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970). There is an inverse relationship between opportunity for exit and exercise of voice: voice increases as opportunities for exit decline; yet voice can serve as a substitute for exit. Loyalty is the key variable in the choice between exit and voice, because members who are locked into their organizations are more likely to make themselves heard: "Loyalty holds exit at bay and activates voice." *Id.* at 78.

162. *See, e.g.*, Lon L. Fuller, *Human Interaction and the Law*, 14 AM. J. JURIS. 1, 10 (1969) (asserting that the function of law is to produce an ordered relationship among members of society); MACNEIL, *supra* note 133, at 93 (arguing that law provides for the accomplishment of cooperation); Chayes, *supra* note 3, at 32 (noting importance of creation of legal institutions that encourage socially useful behavior).

163. MACNEIL, *supra* note 133, at 93.

164. *See* William W. Bratton, *Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law*, 61 GEO. WASH. L. REV. 1084, 1116 (1993).

point is that, as Professor Michael Young has shown, private ordering in Japan is often *governmentally structured and encouraged*.[165] Put differently, law matters, even in repeated deals.[166]

B. Bargaining Endowments

State-supplied rules, mechanisms and institutions can serve as "bargaining endowments"[167] to private parties. They provide the background norms against which parties negotiate deals and regulate conduct.[168] The regulatory environment and judicial activity that support relational governance in Japan are examined below.

1. Regulatory Endowments

a. In the Banking Industry

Japan offers a dramatic illustration of the way regulation of corporate finance affects corporate governance.[169] As this section shows, the legal system, supported by government policy and swayed by historical events, has created a bank-centered system of corporate finance and control. Legislation, in turn, facilitates the administrative guidance that animates financial oversight. Regulatory constraints are thus fundamental to the deals borrowers have traditionally struck with their bankers.[170]

Bank finance has historically been more important to Japanese industry than securities-based finance. The predominance of bank finance can be traced to several factors: government encouragement of the banking system to promote modernization,[171] interest rate controls,[172]

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165. Young, *supra* note 135.

166. *See* Ramseyer, *Repeated Deals*, *supra* note 7, at 96–106.

167. *See* Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950 (1979); Galanter, *supra* note 36, at 6.

168. *See* Galanter, *supra* note 36.

169. *See* Roe, *supra* note 75, at 1936 ("How a nation regulates capital's deployment will affect how firms are organized.").

170. For other discussions of this theme, see FRANCES MCCALL ROSENBLUTH, FINANCIAL POLITICS IN CONTEMPORARY JAPAN 138–50 (1989); Ramseyer, *Repeated Deals*, *supra* note 7, at 97–100.

171. In contrast to the banking industry, which reached a highly developed state in the late 19th century, the public offering market did not fully develop until after World War II. *See* Alan Beller et al., *Looks Can Be Deceiving—A Comparison of Initial Public Offering Procedures Under Japanese and U.S. Securities Laws*, 55 LAW & CONTEMP. PROBS. 77, 91 & App. no. 4. (1992) (listing data indicating general shallowness of public capital markets prior to World War II). While capital markets were utilized by newly formed corporate groups in the 1920s and 30s, stock market financing all but disappeared during the Second World War. In 1945, for example, 93% of all funds procured were in the form of bank loans. Akira Kubota, *Sensō makki no shōken shijō [Securities Markets During the Final Phase of the War]*, *in* SHŌKEN HYAKUNEN SHI [A ONE-HUNDRED YEAR HISTORY OF SECURITIES] 173, 174 (Hiromi Arisawa ed., 1978) [hereinafter SECURITIES HISTORY].

172. Interest rate controls were instituted in the immediate postwar period to ensure a flow

loan market segmentation,[173] and a variety of legal and practical limitations on bond issuance that stunted the growth of the capital markets.[174] By hampering the development of the capital markets for many years, these constraints locked many firms into long-term relationships with their lenders and enhanced the power of the banks.[175] Laws and bureaucratic directives not only supported bank finance, but they also institutionalized the practices that would become the main bank system in the postwar period. In the late 1930s, the mobilization of resources for the war effort resulted in the passage of legislation and government orders that created bank loan rationing and a compulsory lending system.[176] Banks were required to lend to critical industries

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of capital to industry. Companies came to depend heavily on the low-cost funds supplied by banks, resulting in excessive demand by the city banks for Bank of Japan credit. As the leading city banks, which had been affiliated with the prewar *zaibatsu*, stepped up lending to major corporations and reacquired shares in former affiliates in the immediate postwar period, the modern-day *keiretsu* system emerged.

173. Recognizing the importance of developed capital markets for a healthy postwar economy, Occupation reformers conceived of a U.S.-style division of long- and short-term finance for Japan. Banks would provide short-term commercial loans, while stocks and bonds issued on public securities markets would provide sources of long-term financing. Kiichi Shimura, *Kin'yū, shōken seido no kaikaku* [*Reform of Financial and Securities Systems*], *in* SECURITIES HISTORY, *supra* note 171, at 186, 186–87. But historical realities intervened. The onset of the Cold War convinced the U.S. authorities that Japanese economic stability, enhanced by government-business cooperation and economic concentration, must take precedence over the introduction of a U.S.-style financial system. *See* Kazuo Ueda, *Kin'yū shisutemu, kisei* [*Financial System, Regulations*], *in* GENDAI NIHON KEIZAI SHISUTEMU NO GENRYŪ 35, 53 (Tetsuji Okazaki & Masahiro Okuno eds., 1993); T.J. PEMPEL, POLICY AND POLITICS IN JAPAN: CREATIVE CONSERVATISM 50 (1982).

In order to supplement long-term financing by ordinary financial institutions, the Japan Export Bank and the Japan Development Bank were established pursuant to legislation in 1950 and 1951, respectively. The Long-Term Credit Bank Law was passed in the following year, authorizing three long-term credit banks to issue debentures, accept long-term deposits, and raise other long-term funds for lending to industry. In addition, a Loan Trust Law authorized prewar trust companies to absorb the public's long-term funds and channel them into critical industries. *See* TAKAFUSA NAKAMURA, THE POSTWAR JAPANESE ECONOMY: ITS DEVELOPMENT AND STRUCTURE 140–41 (Jacqueline Kaminski trans., 1981).

174. Underdeveloped markets for government bonds stunted the growth of the securities markets. Before 1975, government bonds were sold at above-market prices to a captive syndicate of financial institutions, which underwrote and then held a given portion of the bonds from each issuance. MOF restricted the development of a secondary market by prohibiting these institutions from reselling the bonds. Instead, the Bank of Japan repurchased the bonds after they had been held by the underwriters for at least one year. JAMES HORNE, JAPAN'S FINANCIAL MARKETS: CONFLICT AND CONSENSUS IN POLICYMAKING 53–54 (1985).

A variety of restrictions hampered the development of a corporate bond market as well. Strict eligibility standards, collateralization requirements, and a cumbersome commissioned bank trustee system for management of collateral restricted the flexibility and increased the cost of domestic bond issues. Following the war, bond issuance was bootstrapped into the system of bank finance, first through Bank of Japan screening of potential bond issuers and later by private rating systems. Both methods ensured a concentration of funds in core industries because only major companies that could obtain bank loans were deemed eligible to issue bonds. For a history of the Japanese bond market, see ROSENBLUTH, *supra* note 170, at 138–50.

175. Toshihiro Horiuchi, *The Effect of Firm Status on Banking Relationships and Loan Syndication*, *in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 7, at 258, 263–66.

176. Teranishi, *supra* note 88, at 65. Bank loan rationing was instituted in September 1937 through the Temporary Fund Adjustment Act [*Rinji shikin chōseihō*]. A compulsory lending system

and government-managed enterprises. Loan syndications were used to reduce risks by diversifying loans.[177] As the war became more protracted, bureaucrats stepped up direct control over production in a shift toward a more totalitarian planned economy. Loan syndications were transformed into a mechanism for channeling funds to munitions companies.[178] In the postwar period, the main bank system emerged out of the institutionalized practice of loan syndication as banks responded to the dual need for loan diversification and corporate monitoring efficiency.[179]

Bank-borrower relationships are also sustained in other ways by the informal guidance of the financial bureaucrats. While banks have been the beneficiaries of protective governmental regulation in the postwar period,[180] it has not come entirely without cost. For instance, MOF has often pressured banks to save troubled borrowers.[181] As a result, banks have been constrained in their ability to jettison unwanted clients. The relationship between the banks and the government created a regulatory framework with reciprocal barriers to exit for banks and their corporate borrowers, encouraging long-term, repeat play in the Japanese financial industry.

An environment conducive to the informal guidance that animates this regulatory scheme is itself facilitated by statute.[182] MOF's sweep-

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[*meirei yūshi seido*] was instituted in March 1939 by government order [*Kaisha rieki haitō oyobi shikin un'yō rei*]. *Id.*

177. *Id.* at 70–71.

178. *Id.* at 73.

179. *Id.* at 75–80.

180. For example, under MOF's "convoy" policy, banks enjoy an implicit guarantee of financial survival. Moreover, because MOF has exercised its licensing authority over the banking industry to dramatically reduce the number of industry participants (by encouraging mergers while refusing permission for new entrants), banks enjoy limited domestic competition. Banks have also benefitted from government policy to promote bank finance over securities finance. For an extended discussion of the protection provided by government regulation of the banking industry, see Kazuo Ueda, *Institutional and Regulatory Frameworks for the Main Bank System, in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 7, at 89, 89–99.

181. *See, e.g.*, James Sterngold, *No Letup in Japanese Bank Crisis*, N.Y. TIMES, Oct. 1, 1994, at 41 (reporting that bank's involvement in the rescue of two financing companies was motivated by heavy MOF pressure). The role of the government in bank rescues is suggested by a case brought by trade creditors of a financially troubled borrower against the borrower's main bank. The bank, under pressure from the national and prefectural governments as well as the Small and Medium Business Association to provide assistance to the struggling firm, seconded personnel to the borrower, worked out a plan with creditors to keep the company afloat, and assured the firm in writing that it would continue to provide working capital. The trade creditors sued—to no avail—when the bank reneged on the written promise. Judgment of May 26, 1988, (Yuasa Sangyō v. Shōkō Sōgō Chūō Kinko), Tokyo Chisai [Tokyo District Court], 823 KIN'YŪ SHŌJI HANREI 27.

182. To be sure, administrative guidance is also facilitated by the *absence* of law. One of the main reasons for the relative informality and insularity of Japanese administrative activity is the absence of a statute clearly specifying agency procedures and the terms of judicial review of agency action.

ing interpretation of its jurisdictional mandate to include all aspects of corporate finance as well as public economic well-being is supported by the expansive legislation that establishes the ministry.[183] Administrative guidance in financial oversight is promoted by such statutes as the Banking Law of 1927, the principal banking statute for over half a century. This statute functioned only as a broad administrative framework that left most of the regulatory details and discretion to MOF.[184]

b. In Employment Relations

The cooperative labor relations that figure so prominently in the Japanese corporate contract are not culturally or historically predetermined. In fact, the history of Japanese labor relations from early industrialization through the 1950s is one of considerable conflict and confrontation.[185] The labor practices now identified with Japan's remarkable economic success are both a recent, and in part, legally derived phenomenon.

Throughout the postwar period, Japanese policymakers used legislation and administrative organs to alternately curb or reinforce social, market, and demographic trends deemed important to productive and smooth industrial relations.[186] In the immediate postwar period, a panoply of labor laws was enacted to implement the modern welfare state contemplated by the new Constitution. Labor legislation enacted in the 1960s was designed to promote rapid expansion of the economy and to alleviate labor shortages caused by accelerated growth. More recently, a host of laws has been enacted to deal with the effects of structural changes in the Japanese economy, such as increased participation of women in the workforce, unemployment, and the growing tendency of the lifetime employment system to be group-based rather than firm-based.

While the lifetime employment system is not legally mandated, Japanese labor legislation, particularly as interpreted by the courts,[187] has helped to create malleable, long-term employment practices that, as shown in Part II, have a major influence on managerial behavior.

183. Ōkurashō setchihō [Ministry of Finance Establishment Law], Law No. 144 of 1949. The establishment law grants the ministry jurisdiction over both the collection and expenditure of public funds as well as over the banking, securities, and insurance industries. MOF's jurisdiction thus encompasses substantive areas overseen in the United States by a half dozen federal agencies in addition to state regulators.

184. Ueda, *supra* note 180, at 90–91; Masaru Mabuchi, *Deregulation and Legalization of Financial Policy*, *in* POLITICAL DYNAMICS IN CONTEMPORARY JAPAN 130, 150 (Gary D. Allinson & Yasunori Sone eds., 1993). The Banking Law of 1927 was completely revised in 1981.

185. *See* Sugeno, *supra* note 126, at 288–310 (providing a history of labor-management conflict in the pre- and postwar periods).

186. *See id.* at 294–317.

187. *See infra* notes 213–219 and accompanying text.

For example, on-the-job training,[188] flexible work assignments and job transfers,[189] and the distinctive structure of Japanese collective bargaining, which channels confrontation outside of mainstream labor negotiations[190] and allows the enterprise union system to serve as a facilitator of smooth, productive relations,[191] are supported in part by state-supplied legislative endowments.

2. Judicial Endowments

In highly relational contexts, which are characterized by complex and undefined obligations, judicial enforcement of general legal principles to fill gaps in incomplete contracts and to punish opportunism may be *the* most important function of law. Not surprisingly, this is precisely the function performed by the Japanese judiciary in banking and employment relations.

a. In the Banking Industry

In addition to the regulatory supports described above, bank-borrower relations are also sustained by the courts. Notwithstanding all of the supposedly informal cooperation and implicit (unenforceable) contracting in the world of Japanese banking,[192] and despite the reported aversion of

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188. *See* Michio Kurokawa, *Korekara no shokugyō nōryoku kaihatsu to hōritsu seisaku no kadai [Upcoming Issues in Human Resource Development and Legal Policy]*, 1066 JURISUTO 87 (1995).

189. *Cf.* Shigeo Nakayama, *Rōdō keiyaku hōsei no arikata—rōkiken rōdō keiyakutō hōseibukai hōkoku ni tsuite [The Goals of Labor Contract Legislation: On the Report of the Labor Contract Legislation Committee of the Labor Standards Council]*, 1066 JURISUTO 163 (1995) (arguing against various proposals that would further codify existing labor procedures, since current legislation and judicial decisions promote conditions favorable to long-term employment system).

190. The rights of workers to organize and to bargain collectively are guaranteed by Article 28 of the Japanese Constitution. The Trade Union Law governs the formation and activities of labor unions and seeks to promote collective bargaining on the basis of equality between employers and employees. KAZUO SUGENO, JAPANESE LABOR LAW 416–18 (Leo Kanowitz trans., 1992).

191. Japanese law grants the right to bargain collectively to each union organized within an enterprise, regardless of its majority or minority status. Thus, cooperative relations can be maintained with the majority union while management carries out more confrontational negotiations with a minority union. Sugeno, *supra* note 126, at 287. *See also* SUGENO, *supra* note 190, at 419–20.

192. Nowhere are the stories of legally unenforceable cooperation more prevalent than with respect to the main bank. With one exception discussed below, legally enforceable contracts have no place in the existing literature on the main bank. Instead, commentators focus exclusively on commitments based on trust and reputation. *See, e.g.*, Patrick, *supra* note 102, at 359 (stating that main bank relationships and commitments are not based on legal contracts). *See also* Litt et al., *supra* note 19, at 443 (emphasizing extra-legal moral arrangements that "depend on a private system of incentives and enforcement rather than on any threat of resort to the courts" in Japanese banking industry). Sophisticated economic explanations posit an informal and hence legally unenforceable "main bank contract" in which the expectation that the bank will rescue the borrower is confirmed. Sheard, *supra* note 19. Similarly, scholars assert that firms pay an implicit insurance premium to their main bank for an informal guarantee that the bank will rescue the borrower if it falls into financial distress.

Only one commentator has seriously taken issue with these explanations. *See* Ramseyer, *Legal* the Japanese to binding agreements and litigation,[193] closer inspection shows that the courts are often utilized in highly sophisticated ways to interpret and enforce agreements to lend. The courts supply important bargaining endowments in two principal ways: by applying a good faith norm to govern repeated dealings and by discerning the existence and contours of legally enforceable expectations in financial transactions.

Although discussions of the good faith principle in Japanese law are virtually nonexistent in the English-language literature, the doctrine is instrumental in imbuing all contractual exchange in Japan with an enforceable legal norm.[194] Indeed, in overlooking the use of good faith, observers have overlooked a substantial body of judge-made law that contradicts a host of often repeated but undocumented assertions about the general absence of contracts, law, and litigation in corporate Japan.

As applied by courts in both Japan and the United States, good faith is a highly relational principle.[195] It serves as a gap filler in contractual exchange by supplying a flexible ex post norm to cover unforeseen situations that are the hallmark of long-term, multiplex interaction. By invoking the doctrine of good faith, courts supply a legal rule that takes into account norms generated by a relationship.[196] The nature and extent of the relationship is thus a key factor in the decision whether judicial intervention is justified.

The obligation of a contracting party to deal in good faith at each stage of the contracting process has been affirmed by the Japanese Supreme Court[197] and is actively enforced by the lower courts.[198] The

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Logic, *supra* note 7. Ramseyer argues that these main bank "contracts" remain implicit because they are not made at all. If the parties wished to make such agreements, they could negotiate and draft them. The fact that they do not suggests to Ramseyer that no such agreements exist. *Id.*

193. *See supra* note 15 and accompanying text.

194. *See* Kazuto Yukizawa, *Shōtorihiki ni okeru seijitsu gimu no kinō* [*The Function of the Duty of Good Faith in Commercial Transactions*], 55 SHIHŌ 263 (1993) (arguing that the doctrine of good faith plays a major role in reconciling "external" legal and official norms with "internal" transaction-specific norms in Japanese commercial life). The duty of good faith and fair dealing derives from Article 1(2) of the Civil Code: "The exercise of rights and the performance of duties shall be carried out in accordance with the principles of good faith and trust." For an in-depth analysis of good faith in the evolution of Japanese contract theory, see Takashi Uchida, *Gendai keiyakuhō no aratana tenkai to ippan jōkō (1)* [*Modern Contract Law: New Developments and General Provisions (Part I)*], 514 NBL 6 (1993).

195. In the Japanese literature, see, e.g., Uchida, *supra* note 194. On U.S. application of the doctrine, see, e.g., A. Brooke Overby, *Bondage, Domination, and the Art of the Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation*, 61 FORDHAM L. REV. 963, 989–90 & n.141 (1993) (discussing the relational underpinnings of good faith); Macneil, *supra* note 21, at 885 (1978); Goetz & Scott, *supra* note 28, at 1136–40.

196. *See* Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 827 (1982) ("It is one function of the good-faith performance doctrine to enforce the spirit of deals, including their unspecified inner logic.").

197. Judgment of September 18, 1984, (Ikeda v. Kadotani), Saikosai [Supreme Court], 1137 HANJI 51 (finding that beyond a certain stage in contract negotiations, unilateral termination of negotiations without just cause gives rise to damages).

198. Seiji Kawakami, *Yūshi keiyaku seiritsu katei ni okeru kin'yū kikan no sekinin*, [The Liability

good faith principle creates an interim tort-like basis of liability at the contract formation stage. Prior dealings heighten the probability that negotiations will give rise to justifiable expectations of contract formation, imposing on both parties the obligation to continue negotiations with due care and in good faith.[199] The probability of judicial application of the good faith principle thus increases "with the maturity of the contract."[200]

The Osaka District Court articulated the good faith principle in an award of damages against a financial institution. It held that once the parties

> have begun negotiating with a view to entering into a contract, and negotiations have progressed to a stage where the parties have begun to place a degree of confidence in each other, . . . a legal relationship which is governed by the principle of good faith and fair dealing . . . is deemed to have come into existence. Once the parties are bound by such a legal relationship, they . . . are obligated to deal with each other in such a way as to cause the least possible damage to each other's honor, reputation, or assets.[201]

Japanese courts have developed the good faith doctrine over many decades in the course of determining the bounds of legally enforceable expectations arising out of business dealings.[202] The banking industry has supplied a substantial number of such disputes for judicial resolution.[203] Would-be borrowers have frequently sued banks on the theory

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of a Financial Institution at the Financing Contract Formation Stage], 1399 KIN'YŪ HŌMU JIJŌ 6, 10 (1994). Good faith obligations often arise in land sale transactions where the buyer or seller withdraws from a deal before a definitive sales contract has been concluded, but after substantial negotiations and preparation for performance have taken place. *See, e.g.*, Judgment of Jan. 26, 1993, (Katabami Shōji K.K. v. Eiroku Kensetsu K.K.), Tokyo Chisai [Tokyo District Court], 1478 HANJI 142 (holding that no contract was formed, but a duty of care based on good faith principles was breached where parties had developed close relationship during negotiations directed at contract formation).

199. Kawakami, *supra* note 198, at 10.

200. *Id.*

201. Judgment of Oct. 12, 1990, (Nihon Jetto K.K. v. Biwako Ginkō K.K.), Osaka Chisai [Osaka District Court], 1280 KIN'YŪ HŌMU JIJŌ 34, 38 (holding that a bank has a good faith obligation to protect prospective client's interests in view of imminent contractual relationship).

202. The doctrine, a German import, was first applied by the Japanese courts in the 1920s. Takashi Uchida, *Gendai keiyaku hō no aratana tenkai to ippan jōkō (3)* [*Modern Contract Law: New Developments and General Provisions (Part III)*], 516 NBL 22 (1993).

203. Involvement of the courts is needed particularly because Japanese code law does not provide clear guidance on when, short of actual delivery of funds to the borrower, a legally binding loan agreement comes into existence. *See* CIVIL CODE art. 587. Commentators are divided on whether a consensual contract can be formed solely by agreement of the parties. The Supreme Court, whose decisions are highly persuasive, though lacking in stare decisis effect, has determined that it can. Judgment of Mar. 16, 1973, (no party names given), Saikōsai [Supreme Court], 683 KIN'YŪ HŌMU JIJŌ 25. Even among subscribers to this view, there is a difference of opinion on whether an oral promise, without more, is sufficient to create a binding obligation to lend.

that past dealings gave rise to a duty to lend.[204] While the borrowers are not always successful in their claims, this line of cases demonstrates a high degree of "contract consciousness" among Japanese commercial actors.[205] It also suggests that parties to banking relationships as well as the courts are willing and able to distinguish between legally enforceable and unenforceable agreements, even in the course of ongoing relationships. Among this body of case law is a partially successful suit by a borrower against its main bank for reneging on a written commitment to fund an important project,[206] an occurrence that is not predicted by the theories of wholly extra-legal main bank relations.

Banks, for their part, also make extensive use of the legal system for their protection. Professor Mark Ramseyer has analyzed data indicating that banks regularly demand security interests and third party guarantees from prospective borrowers.[207] They also base relationships with their customers on a detailed standard form contract[208] developed by the Federation of Bankers Associations in 1962, in response to a judicial decision adverse to a major bank.[209] Virtually every provision

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The majority view is that some physical evidence is necessary to support an oral promise. *See* Osamu Saito, *New Developments in Arguments on Legal Liability of Financial Institutions*, 11 BANK OF JAPAN MONETARY & ECON. STUD. 97, 104–05 & n.10. (1993). These issues are complicated by Articles 556 and 589 of the Civil Code, which contemplate an interim category of obligation typically referred to as a "commitment agreement" [*yoyaku keiyaku*], which is essentially an option granted by the financial institution in favor of the prospective borrower. *See id.* at 103–04 & nn.9–10.

204. *See, e.g.*, Judgment of March 16, 1973, (no party names given), Saikōsai, [Supreme Court], 683 KIN'YŪ HŌMU JIJŌ 25 (holding that a bank has a duty to lend where consensual consumer loan had been formed, where borrower had offered to provide the required security for the loan but bank had delayed performance); Judgment of Feb. 1, 1994, (Purinetto K.K. v. Mitsubishi Ginkō K.K.), Tokyo Kōsai [Tokyo High Court], 1390 KIN'YŪ HŌMU JIJŌ 32 (holding main bank liable in tort for failure to extend loan after issuing written commitment in course of negotiations); Judgment of March 3, 1970, (Tōkai Shokufun v. Nihon Kangyō Ginkō), Tokyo Chisai, [Tokyo District Court], 580 KIN'YŪ HŌMU JIJŌ 29 (finding that no financing contract exists where would-be borrower has taken steps to restructure business in expectation of loan from bank, where bank had held discussions about financing but before agreement to lend has been conclusively reached); Judgment of Jan. 20, 1989, (Fukushima Seitai Kōgyō K.K. v. Nishimonoshinyō Kinko), Miyazaki Chisai [Miyazaki District Court], 733 HANTA 118 (finding that no financing contract exists where, in spite of close relationship between bank and borrower and discussions regarding possible financing between customer and bank branch manager, customer had not yet submitted loan application and branch manager had not discussed matter with head office); Judgment of Sept. 28, 1989, (Hosoya v. Chūbu Ginkō K.K.), Shizuoka Chisai [Shizuoka District Court], 1254 KIN'YŪ HŌMU JIJŌ 37 (finding that no financing contract exists where potential borrower has relied upon informal assurances by agent of lender that loan application would be granted).

205. For literature asserting that Japanese lack such consciousness, see *supra* note 15.

206. Judgment of Feb. 1, 1994, (Purinetto K.K. v. Mitsubishi Ginkō K.K.), Tokyo Kōsai [Tokyo High Court], 1390 KIN'YŪ HŌMU JIJŌ 32 (holding main bank liable in tort for failure to extend loan after issuing written commitment in course of negotiations). For a more extensive discussion of this case, see *infra* notes 259–261 and accompanying text.

207. *See* Ramseyer, *Repeated Deals*, *supra* note 7.

208. Ginkō torihiki yakujōsho [Bank Transaction Agreement] (on file with author).

209. *Kin'yū hōmu no atarashii kadai* [*New Topics in Financial Law*], 447 TEGATA KENKYŪ 4, 4 (1991).

of the standard form contract has been litigated.[210] Banks also consult widely with outside counsel. Recent survey data indicate that almost all banks consult with attorneys on debt management and collection as the need arises.[211] The largest banks retain between ten and forty law firms, consulting with up to two hundred attorneys.[212]

b. In Employment Relations

The courts also play a major facilitative role in Japanese employment relations. Judge-made law supports the lifetime employment system by supplying bargaining endowments to both employers and employees, enabling malleable, long-term employment patterns.[213] For employees, judicial precedent places substantial constraints on an employer's ability to dismiss workers, even under conditions of financial hardship. For employers, the case law supports adjustment of work rules and ambiguous demarcation of job requirements, facilitating job rotation and transfer.

Although there is no legislation requiring just cause for dismissal of employees lacking employment contracts, Japanese courts have utilized the civil law abuse of rights doctrine[214] in formulating a standard against which to gauge the validity of dismissal. Under the standard, a dismissal that is not "objectively reasonable and socially appropriate" is an abuse of rights and therefore void.[215] Courts have strictly construed the standard in favor of employees and have reversed the usual burden of proof in recognition of the importance of employment security.[216] Moreover, the courts apply a strict standard that limits the rights of employers to dismiss workers even where workforce reductions are motivated by economic necessity.[217]

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210. *See, e.g.*, Masakazu Suzuki, *Ginkō torihiki yakujōsho to sore wo meguru hanrei [The Bank Transaction Agreement and Related Cases]*, 476 TEGATA KENKYŪ 50 (1993) (first of ongoing and extensive series of articles examining litigation over standard form bank contract).

211. *Kin'yū kikan yūshi kanri sekushon jittai chōsa [Survey of Finance Management Sections of Financial Institutions]*, 1400 KIN'YŪ HŌMU JIJŌ 57, 63 (1994) [hereinafter *Survey of Finance Management Sections*] (92% of 104 banks responding to survey).

212. *Kin'yū kikan hōmu sekushon jittai chōsa [Survey of Legal Sections of Financial Institutions]*, 1375 KIN'YŪ HŌMU JIJŌ 76, 78 (1994) [hereinafter *Survey of Legal Sections*].

213. *See* Takashi Araki, *Flexibility in Japanese Employment Relations and the Role of the Judiciary*, *in* JAPANESE COMMERCIAL LAW IN AN ERA OF INTERNATIONALIZATION, *supra* note 126, at 249.

214. This doctrine derives from Civil Code art. 1(3), which provides simply that "[n]o abuse of rights is permissible." The doctrine is invoked in numerous contexts to prevent the exercise of rights technically provided by law in a manner harmful to the interests of others.

215. Judgment of April 25, 1975, (The Nihon Shokuen Seizō Co. Case), Saikōsai [Supreme Court], 29 MINSHŪ 456, 458. For a discussion of the case in English, see Araki, *supra* note 213.

216. Araki, *supra* note 213, at 252.

217. *Id.* at 254–55. The employer must show that (a) there was an economic need for labor force reductions, (b) efforts were made to avoid involuntary reductions, (c) only appropriate workers were selected for dismissal, and (d) dismissal was procedurally proper, which often entails prior consultation with the union. *Id.* In a recent case, an employee filed suit after he was dismissed for allegedly lackluster performance. The Tokyo District Court found for the employee,

In contrast to these exit barriers that limit employers' rights to terminate employment relations, the courts enhance employers' discretion concerning job transfer, assignments, and training.[218] Employees working within the lifetime employment system do not sign employment contracts, and are not hired to fill a specific job description. Instead, they are hired as generalists, and can expect to be rotated through numerous departments and branch offices throughout their career. This flexibility is key to the firm's ability to utilize the employee's services over the entire course of his or her career, and through variable economic states of the firm over time. The first-hand view of many aspects of the firm that this provides is also believed to develop sound managerial expertise of white-collar workers, and to enhance the knowledge and work quality of blue-collar workers. The judiciary facilitates this employment pattern for both white- and blue-collar workers by rarely invalidating transfer orders and by permitting the scope of the implied labor agreement to remain ambiguous.[219]

C. *A Reassessment*

The data invite a reassessment of the existing literature. Constraints on parties in relational contexts come in many forms. To the list of reputation, moral commitment, and self-enforcing contracts must be added legislation that restricts exit from relationships, implied contractual terms that are judicially enforceable, and a regulatory structure that facilitates intensive interaction with government officials. Law in Japan is at work most intensely in precisely those areas that provide the strongest corporate governance checks—banking, administrative oversight, and employment.

In the banking industry, the Japanese legal system both creates and mitigates opportunism; both the creation and mitigation suggest something important about the operation of the main bank and its occasional, but by no means automatic, assistance to failing firms. Because the Japanese regulatory environment essentially crippled capital market finance for all but the largest firms, borrowers were susceptible to opportunistic behavior by the banks in the form of termination of the relationship if it proved unprofitable.[220] In fact, there is evidence that such opportunistic withdrawal does occur to the detriment of the

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on the ground that dismissal was actually based on the firm's deteriorating financial condition. *See The Employees Strike Back: Workers Challenging Layoffs, Dismissals—And Winning*, NIKKEI WKLY., Aug. 15, 1994, *available in* LEXIS, World Library, Allwld File.

218. *See* Nakayama, *supra* note 189.

219. Araki, *supra* note 213, at 265–69.

220. *See* Sheard, *supra* note 109, at 188, 206–09 (discussing possibility that main banks may opportunistically withdraw from a borrower to extract information rents in certain circumstances).

borrower[221] and other creditors.[222] This evidence, coupled with the additional data indicating extensive use of legal mechanisms in the banking industry, buttress the conclusion reached by Mark Ramseyer that there are no ex ante agreements to rescue troubled debtors in Japan.[223] Banks do not make explicit contracts to intervene in the management of and to save troubled borrowers because ex ante, they cannot predict if such actions are in their interests. And precisely because Japanese courts *are* capable of enforcing such a bargain if struck, or of holding a bank liable for breach of the duty of good faith in behaving opportunistically in connection with such an agreement, banks do not make such promises. Fearing the legal consequences, banks ex ante keep quiet about the possibility of restructuring failing firms. Ex post, however, banks sometimes determine that it is in their interests to extend additional financing to troubled borrowers because of anticipated revenues from the future transactional relationship.[224]

In the employment context, the legal system enhances the mutual loyalty between employers and employees that already exists due to limited labor mobility. The courts have dulled the sharp edges of legislation that might otherwise be utilized to sever ties. They use relational legal norms to push employers to retain workers, even in the face of economic hardship. At the same time, they compensate for

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221. *See* Judgment of Feb. 1, 1994, (Purinetto K.K. v. Mitsubishi Ginkō K.K.), Tokyo Kōsai [Tokyo High Court], 1390 KIN'YŪ HŌMU JIJŌ 32 (1994) (main bank conditioned financing of project on borrower's termination of main bank relationship).

222. *See* Judgment of May 26, 1988, (Yuasa Sangyō v. Shōkō Sōgō Chūō Kinko), Tokyo Chisai [Tokyo District Court], 823 KIN'YŪ SHŌJI HANREI 27 (main bank refused to fund import of raw materials awaiting offloading at dock after assuring other creditors that it would continue to supply working capital to financially distressed borrower under the main bank's management).

223. Ramseyer, *Legal Logic*, *supra* note 7. Ramseyer persuasively argues that if the parties to a banking relationship wished to write such a contract, they could surely do so. That they do not suggests that no agreements to rescue borrowers exist. Yet to explain why Japanese banks might save troubled firms more often than U.S. banks even in the absence of contractual obligations to extend assistance, Ramseyer argues from an *absence* of law. He contends that the lack of an equitable subordination doctrine in Japan means that banks are not punished for intervening in management. Thus, he argues, banks cannot credibly commit to letting their troubled borrowers fail. In contrast, U.S. law sometimes punishes banks that intervene in an attempt to save their borrowers. But this theory overlooks evidence examined in Part IV *infra*, showing that Japanese banks are also sometimes punished by the legal system for intervening in management.

224. Akiyoshi Horiuchi et al., *What Role has the "Main Bank" Played in Japan?*, 2 J. JAPANESE & INT'L ECON. 159, 178 (1988). Logically, the second scenario—payoff from a continuing relationship—is more likely in a growing economy; indeed, most of the cases of bank-led restructurings cited by scholars occurred in Japan's high-growth era. *See* Sheard, *supra* note 109, at 213–26 (listing 27 restructurings from the 1960s to the mid-1980s, compared with 14 cases more recently, of which several were prompted by governmental arm twisting). From this perspective, disharmony in banking relations should appear principally in "final periods" when the banks are no longer willing or able to repeat the game for those borrowers on the fringe. A series of lender liability cases discussed in Part IV suggests that precisely this scenario is beginning to occur.

legally coerced long-term employment patterns by granting employers broad discretion in determining employees' specific functions and assignments.

The evidence, then, indicates that the Japanese state provides a highly effective framework for corporate cooperation. It also shows that the Japanese do not hesitate to use the framework provided. Corporate actors utilize legal devices and institutions to structure and enforce their deals; courts apply sophisticated legal norms to gauge the enforceability of their expectations. Parties avoid legal devices when they cannot or do not wish to specify obligations in detail ex ante. None of this should surprise us: parties use the legal system to their advantage; the legal system responds.[225] Yet none of this should occur if, as is often asserted, the Japanese lack confidence in their legal system, or if mechanisms of informal enforcement always satisfy their contracting needs at lower cost. In Japan, as elsewhere, parties bargain in the shadow of the law. By holding parties into long-term relationships and by legally enforcing the norms that arise out of repeated interactions, the Japanese legal system casts a considerable shadow. The next Part suggests that the shadow is lengthening.

IV. JAPANESE CORPORATE GOVERNANCE IN TRANSITION: TOWARD A NEW EQUILIBRIUM?

Yet as an economy changes, as it grows more complex, as bargains become more frequent, as new types of bargain appear, the ritual forms theretofore established on older models must prove inadequate to cover all engagements-in-fact, inadequate to protect all reliance-in-fact.[226]

Relational theory predicts that as relationships become more distant and fleeting, formal law and procedures will take on increased prominence in ordering exchange.[227] Evidence suggests that this transition is occurring in Japan. As the economic, social, and political setting in which Japanese corporate exchange is embedded undergoes significant changes, there are numerous signs that the interactions constituting and constraining the Japanese firm are evolving—tentatively to be sure—from highly relational to more discrete affairs. The corrosive impact of regulatory and economic pressures has expanded opportunities for exit from banking relationships and increased the treatment of corporate interaction as arm's length exchanges.[228] Repeated deals are

225. Imperfectly, to be sure, but no more or less imperfectly than legal systems elsewhere.
226. Llewellyn, *supra* note 79, at 712.
227. *See supra* notes 37–39 and accompanying text.
228. *Cf.* Bratton, *supra* note 164, at 1114–15 (discussing expanded opportunities for exit and their effects on corporate relationships in the United States).

thus increasingly encountering final period problems. As a result, formal legal rules and enforcement mechanisms are increasingly being used in place of private orderings to constrain opportunism and to shape relationships.[229] The heightened legal risks confronting Japanese corporations are a reflection of the breakdown in traditionally smooth relations at each level of the corporate enterprise. This Part explores the changing environment for Japanese corporate governance and surveys early evidence that the function of law in the corporate context is evolving from a framework for loyalty-enhancing relationships to a means of resolving disputes ex post. In short, the nexus of constraints appears to be shifting.

A. A Dynamic Environment

To state the obvious, Japan has changed dramatically since the wartime, economic recovery, and high growth eras in which the institutions of corporate governance were formed. As a result, the highly organic linkages outlined in Part II that shape the Japanese firm and the environment in which it operates have been subjected to powerful forces, particularly over the past decade. Deregulation, internationalization, recession, and political change have all worked to erode the foundations of the socio-economic order on which relational governance is based.

Deregulation poses a major dilemma for relational governance, as Japan seeks to reconcile the benefits of consensual economic management with the increasingly visible costs of informal regulation and enforcement.[230] The challenge is to mesh cooperative public-private economic interplay with the increasing calls for greater transparency and less governmental involvement in the economy. Deregulation efforts have been fueled by the increasing internationalization and interdependence of major economies.[231] Pressure from the United States and

229. Of course, those sectors of Japanese society that stand to lose from increased "legalization" of previously informal relationships can be expected to resist. Indeed, as one reviewer of this Article pointed out, prior indications that Japan was undergoing fundamental change toward litigation-oriented resolution of disputes ultimately proved to be misleading.

230. An official report on deregulation prepared in 1993 implicitly recognizes the dilemma: "Until now, the 'catch up and overtake' style Japanese economic system—which at its best might be called cooperation, at its worst, collusion—has functioned well. But now the time has come to reform the system." KEIZAI KAIKAKU KENKYŪKAI [ECONOMIC REFORM STUDY COUNCIL], KEIZAI KAIKAKU NI TSUITE [ON ECONOMIC REFORM] (Dec. 16, 1993).

231. A recent government trade report captures the nature and urgency of the problem: "It is necessary to recognize the increasing likelihood that Japan's economic system, which has supported our past economic growth, is no longer able to adapt to the changing international environment." TSŪSHŌ SANGYŌ SHŌ [MINISTRY OF INTERNATIONAL TRADE AND INDUSTRY], TSŪSHŌ HAKUSHO [WHITE PAPER ON TRADE] 316 (1995). The report warns that unless structural reform is undertaken quickly to remedy the causes of Japan's declining international

other trading partners has, with varying degrees of success, hastened these efforts.[232]

The complexity of administrative and regulatory reform is compounded by the most severe and protracted recession in postwar Japanese history and a highly unstable political situation. Since the asset bubble began to collapse at the end of 1989, the Nikkei Stock Average has lost roughly half its value.[233] Unemployment stands at its highest level since the early 1950s.[234] Banks are burdened with staggering amounts of uncollectible debt,[235] and within the past year there has been serious discussion of a financial meltdown in Tokyo. The number of corporate bankruptcies has soared.[236] Perhaps it is no coincidence that the crest of these developments was punctuated by major political change. The governing Liberal Democratic Party's defeat in lower house elections in 1993 marked the end of almost forty years of uninterrupted LDP rule. Economic and political reform now dominate Japanese public policy debate.

These forces have coalesced most dramatically in the financial industry, challenging the continued viability of Japanese banking practices. The dominance of bank finance began to wane in the mid-1970s with the growth of a secondary market in government bonds and a series of financial reforms[237] that created for the first time the incentives and opportunities for firms to seek capital market financing. In the period 1981–1985, issues of equities and related instruments accounted for one-fourth of the sources of funds for manufacturing companies; in 1989, they accounted for more than seventy percent.[238] A gradual expansion of securitized financial products has further diversified sources of funding. Recession, in turn, has severely impaired the soundness of the financial system. The decline in the stock market has

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competitiveness, "there will be huge repercussions in areas such as Japan's economy, society and employment." *Id.* at 314.

232. The most pertinent example is the Structural Impediments Initiative between the United States and Japan, which placed shareholders' rights, *keiretsu* trading practices and regulatory transparency atop the bilateral trade agenda.

233. From a high of 38,915 in December of 1989, the Nikkei Stock Average has only recently recovered to the 20,000 level.

234. *Japan Unemployment at Two Million, Worst Since 1953*, Reuters, May 27, 1995, *available in* LEXIS, World library, Allwld file.

235. *Bad Loans in Japan Put at $476 Billion*, N.Y. TIMES, June 9, 1995, at D6 (reporting Ministry of Finance disclosure that bad loans total 40 trillion yen).

236. *See, e.g., 1993 Japanese Bankruptcies Reflect Intractable Recession*, Business Wire, Jan. 20, 1994, *available in* LEXIS, World library, Allwld file; *From Bust to Bust: Bankruptcies Keep Coming*, DAILY YOMIURI, Jan. 26, 1993, *available in* LEXIS, World library, Allwld file.

237. For example, interest rates were deregulated, eligibility criteria for issuance of secured and unsecured bonds were relaxed, and the Foreign Exchange and Foreign Trade Control Law was amended, enabling Japanese firms to access the Euromarket.

238. Clive Crook, *The Japanese Economy: From Miracle to Mid-life Crisis*, ECONOMIST, Mar. 6, 1993, at 6.

limited the banks' ability to write off bad debt and imperils their compliance with Bank for International Settlements (BIS) capital adequacy requirements.[239] Political change affected relations between bureaucrats and politicians, unsettling traditional roles in economic oversight.[240]

Other institutions of relational governance are under enormous stress as well. The continued viability of lifetime employment has been cast into doubt as firms attempt to cut bloated white-collar workforces and utilize more part-time and contract workers.[241] Cross-shareholding practices are eroding as firms sell off slumping shares of affiliates and business partners.[242] The recession has indirectly been blamed even for a rise in violence against corporate executives, as traditional relationships between corporations and organized crime are strained by the demands of banks and other lenders to be paid back for loans extended to crime syndicates during the late 1980s.[243]

B. Dynamic Patterns of Relationships and Legal Controls

This section examines how these profound economic, social, and political changes have affected the corporate contract and the nexus of constraints. Viewed separately, perhaps no single development analyzed below signals a sea change in Japanese corporate governance; taken together, however, these changes suggest that an important shift in the Japanese legal environment is under way, as legal rules and institutions are inserted into patterns of conduct once governed principally through a highly relational order.

1. Main Bank Relations: Lender Liability

The main bank system is under pressure from a change in borrower profile and deterioration in the financial condition of banks caused by the twin forces of financial liberalization and recession. Large firms without strong ties to a main bank were best able to take advantage

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239. A portion of the unrealized gains on bank shareholdings can be counted toward capital to meet BIS minimum capital/asset ratios.

240. *See, e.g.*, *Bureaucrats Loosening Ties to LDP*, NIKKEI WKLY., Nov. 22, 1993, *available in* NEXIS, News Library, Nikkei File.

241. *See Japan Unemployed at Two Million, Worst Since 1953*, Reuters, May 27, 1995, *available in* LEXIS, World Library, Allwld File; *Japan's Lifetime Employment System Faces Turning Point*, Agence France Presse, Oct. 12, 1994, *available in* LEXIS, World Library, Allwld file.

242. *Survey of Japanese Industry*, FIN. TIMES, Dec. 6, 1994, *available in* LEXIS, World Library, Allwld File (reporting that sales of mutual cross shareholdings rose sharply in 1993, to a record 2,148 billion yen); *Kigyō, kin'yū kikan no baikyaku kasoku: mochiai kaisho susumu* [*Acceleration of (Stock) Sales by Corporations and Financial Institutions: The Dissolution of Cross Shareholding Progresses*], NIHON KEIZAI SHIMBUN, Mar. 19, 1994, at 13.

243. JAPAN DIG., Nov. 28, 1994, at 7.

of the new financing possibilities brought about through deregulation of financial products and markets.[244] As firms left the banks in favor of the capital markets, banks moved down market, increasing their lending to smaller firms.[245] Small firms, however, tend to be more ambivalent about their banking relationships, readily switching main banks and diversifying their lenders.[246] Moreover, in the easy credit period of Japan's asset bubble, money was lent to marginal customers.[247] The deterioration in banks' asset quality and weakened earnings have caused banks to reconsider their exposure to risk. Banks are less willing to become involved in financial rescues, even at the urging of the government,[248] and to serve as de facto guarantors of public bond issues.[249] The banks' greatly diminished appetite for credit risk is also a reflection of legal changes that heighten the possibility that bank managers will be sued by their shareholders if they exceed their legal requirements in protecting defaulting bond issuers.[250]

As a result, bank-borrower relationships may have bifurcated between firms with strong main bank relations and smaller or less financially viable firms with more tenuous ties to their bankers. In the latter case, the banking relationship is not embedded in a more substantial network of exchanges. Relational theory predicts two outcomes for bank-borrower relations in the latter case. First, banks should be more likely to withdraw from the relationship, opportunistically or otherwise. Second, borrowers should be more willing to resort to litigation to resolve disputes. As the relationship between banks and their less highly valued clients becomes increasingly distant, there should be an even larger role for law.

Evidence suggests that precisely this outcome is being realized. A rapid rise in lender liability cases threatens to dramatically alter the landscape of Japanese banking.[251] In concept, lender liability is nothing

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244. *See* Campbell & Hamao, *supra* note 107 (firms with established main bank relations stayed with traditional bank loans; movement toward deregulated equity instruments has been greatest among firms not affiliated with one of the major banks).

245. Horiuchi, *supra* note 175, at 258, 269–71.

246. *Id.* at 262.

247. *Id.* at 268.

248. For example, banks resisted participation in the Tokyo Kyodo Bank, a MOF-designed institution formed to rescue two failed credit unions. *See Credit Federation Asked for More Loans for Bailout*, DAILY YOMIURI, Mar. 3, 1995, *available in* LEXIS, World Library, Allwld file.

249. MOODY'S INVESTOR SERVICES, INC., *supra* note 107, at 3–4.

250. *Id.* For a discussion of the new legal environment for shareholder derivative litigation, see *infra* notes 275–282 and accompanying text.

251. For an overview of the cases in comparative perspective with U.S. law, see Hideyuki Kobayashi & Motoyo Kawamura, *Rendā raiabiriti wo meguru kinji no dōkō to kongo no tenbō (jō) [Recent Trends in Lender Liability and Prospects for the Future (Part I)]*, 1405 KIN'YŪ HŌMU JIJŌ 6 (1994); Hideyuki Kobayashi & Motoyo Kawamura, *Rendā raiabiriti wo meguru kinji no dōkō to kongo no tenbō (ge) [Recent Trends in Lender Liability and Prospects for the Future (Part II)]*, 1406 KIN'YŪ HŌMU JIJŌ 30 (1994) [hereinafter *Lender Liability (Part II)*].

new to Japanese banks.[252] Until very recently, however, lender liability was something Japanese bankers feared principally in connection with their loans to litigious borrowers in the United States. But it has become a reality in the newly complex world of Japanese finance. If the spirit of unfettered cooperation ever truly existed between banks and their borrowers, it appears to be dissipating. Recent survey data indicate that bank litigation, while still infrequent compared to the United States, is both relatively common and increasing. Fifty-two percent of the banks responding to a 1994 survey had been involved in litigation as a plaintiff or a defendant between one and five times in the past year.[253] Forty-one percent had been involved in more than five cases in the preceding year.[254] Sixty percent of Japan's major ("city") banks responding to the survey report that cases in which the bank is named as a defendant are increasing.[255]

This last statistic is the most important, because the city banks serve as main banks to their client firms. Assertions of liability by borrowers against their main banks carry the greatest potential significance for Japanese corporate governance. Borrowers appear increasingly willing to sue their main bank if unhappy with the bank's conduct.[256] If borrowers are more willing to sue, bankers may be less willing to create close relationships with borrowers or to support failing firms, particularly if the law imposes enforceable good faith obligations on banks at a relatively early stage of the relationship.[257] If banks are less willing to create flexible and enduring relationships with their borrowers or to assist failing firms for fear of liability, the main bank system unravels, with uncertain consequences for Japanese corporate governance.[258]

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252. In the 1950s, two financially troubled borrowers successfully argued to the Fair Trade Commission that restructuring plans implemented by their respective main banks, including forced resignations of management and unilateral decisions by the banks to dispatch personnel to top management posts, constituted unfair trade practices. *See* KŌSEITORIHIKI IINKAI JIMUKYOKU [SECRETARIAT, FAIR TRADE COMMISSION], Nihon kōgyō ginkō ni taisuru ken [Action against Industrial Bank of Japan], 5 KŌSEITORIHIKI IINKAI SHINKETSUSHŪ [COLLECTION OF DECISIONS OF THE FAIR TRADE COMMISSION] 61 (1953) (finding violation of Art. 19 of Anti-Monopoly Law (unfair trade practices)); KŌSEITORIHIKI IINKAI JIMUKYOKU [SECRETARIAT, FAIR TRADE COMMISSION], Kabushiki kaisha Mitsubishi ginkō ni taisuru ken [Action against Mitsubishi Bank K.K.], 9 KŌSEITORIHIKI IINKAI SHINKETSUSHŪ [COLLECTION OF DECISIONS OF THE FAIR TRADE COMMISSION] 1 (1957) (same).

253. *Survey of Finance Management Sections*, *supra* note 211, at 72 (104 banks responded to survey; 89.6% response rate).

254. *Id.*

255. *Id.*

256. *See infra* notes 259–270 and accompanying text.

257. *See* Saito, *supra* note 203 (arguing against imposition of liability on financial institutions at an early stage).

258. *See* Kobayashi & Kawamura, *Lender Liability (Part II)*, *supra* note 251, at 34–35 (stating that although under the main bank system it is not considered unusual for a bank to become involved in management, if cases continue to be brought on the theory that a financial institution

There are too few cases to make this prediction with certainty. To be sure, there is no tidal wave of litigation. And most of the plaintiffs in the cases that have been brought are marginal players—small firms or firms with less than sterling business reputations. But that is precisely the point. The cases discussed below suggest that banks and their less coveted clients are increasingly encountering final period problems, as banks seek to end the repeated game that they gladly played when times were better. As the banks defect, borrowers respond with litigation.

In 1988, a small printing company approached Mitsubishi Bank, its main bank, for a substantial loan to fund the construction of a factory outside Tokyo. It appears that Mitsubishi deemed the amount of funds requested to be excessive, and was looking for ways to reduce its exposure to the customer. The bank committed itself in writing [*yūshi shōmeisho*] to make a far smaller loan, conditioned on the borrower eliminating its main bank ties to Mitsubishi. The bank then reneged on its commitment to make the loan, ultimately causing the borrower to abandon its project, and sending the borrower's president to the hospital with a nervous breakdown. The company sued the bank for breach of contract.[259] The trial court awarded damages in tort, determining that although an enforceable loan agreement had not yet been concluded, Mitsubishi's loan commitment could not be withdrawn without just cause.[260] The Tokyo High Court affirmed the bank's liability, stressing Mitsubishi's concrete commitment to make the loan to its main bank client and the advanced stage of the borrower's preparations to use the funds.[261]

In another case, Azabu Tatemono, a large real estate company burdened by heavy borrowings, is suing Mitsui Trust, its ex-main bank, in Hawaii state court.[262] Azabu's relationship with Mitsui began to deteriorate as Azabu's fortunes collapsed along with the bubble economy, and as Mitsui named a new president who did not share his predecessor's close personal relationship with Kitaro Watanabe, the nonconformist land developer and sometime greenmailer who started Azabu as a tiny automobile sales company in the 1950s. The dispute

participated in the management of a debtor, "it is likely that 'the lender liability era' will have arrived in Japan in earnest.").

259. *See* Judgment of Jan. 27, 1992, (Purinetto K.K. v. Mitsubishi Ginkō K.K.), Tokyo Chisai [Tokyo District Court], 1325 KIN'YŪ HŌMU JIJŌ 38 (1992), *aff'd in part* Judgment of Feb. 1, 1994, Tokyo Kōsai [Tokyo High Court], 1390 KIN'YŪ HŌMU JIJŌ 32 (1994).

260. *Purinetto*, 1325 KIN'YŪ HŌMU JIJŌ at 38, 42.

261. *Purinetto*, 1390 KIN'YŪ HŌMU JIJŌ at 32.

262. In addition to the case discussed in text, a U.S. subsidiary of EIE International, a large Japanese real estate developer, is suing the Long-Term Credit Bank of Japan in Hawaii on facts similar to the *Azabu* case. *See EIE-related Firm Sued LTCB in Hawaii*, Japan Economic Newswire, Apr. 11, 1995, *available in* LEXIS, World Library, Allwld File.

escalated when Azabu ousted all of the Mitsui Trust executives who had been dispatched to Azabu's board in 1991 as part of the bank's restructuring plan for the troubled company. Mitsui retaliated by terminating its status as Azabu's main bank and announcing its intention to deal with Azabu "as would any ordinary creditor."[263] It followed up on this threat by suing Azabu in Tokyo District Court on a 4.3 billion yen note,[264] setting off the firm's debts against bank deposits,[265] transferring the ownership of pledged shares from Azabu to the bank,[266] and seeking court approval in Hawaii to auction a Waikiki resort hotel.[267] Azabu counterclaimed, charging Mitsui with fraud, wrongful control and domination, breaches of contract and fiduciary duties, and other misconduct in connection with Mitsui's management of Azabu from 1991 to 1993.[268] The counterclaim also seeks punitive damages for Mitsui's conduct toward Azabu.[269] In Japan, Azabu filed a complaint with the Fair Trade Commission, claiming that Mitsui's control over Azabu constituted an unfair trade practice as an abuse of the financial institution's dominant position and improper control of the management of Azabu.[270]

The increasing complexity of financial instruments has also spawned litigation. A large number of suits are being brought by customers against their banks for failing to explain the risks inherent in new financial products.[271] One line of cases involves borrowers suing banks for foreign currency-related "impact loans" that were promoted by the banks to their smaller corporate borrowers in the 1980s.[272] Numerous borrowers sued when these loans wound up costing them far more than anticipated due to the appreciation of the yen, claiming that the banks

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263. *Mitsui shintaku shusshin shachōra yakuin azabu tatemono ga zen'in kainin [Azabu Tatemono Dismisses President and All Directors Seconded by Mitsui Trust]*, NIHON KEIZAI SHIMBUN, Mar. 11, 1993, at 1.

264. *Mitsui shintaku gin azabu tatemono wo teiso [Mitsui Trust Sues Azabu Tatemono]*, NIHON KEIZAI SHIMBUN, June 5, 1993, at 2.

265. *Tezumari mitsui shintaku azabu wo "hyōrōzeme" [A Hard Pressed Mitsui Trust Pursues "Starvation Tactics" against Azabu]*, NIHON KEIZAI SHIMBUN, Aug. 12, 1993, at 4.

266. *Id.*

267. *Mitsui Trust to Auction Hotel in Hawaii*, Reuters, Oct. 7, 1993, *available in* LEXIS, World Library, Allwld File.

268. Defendant Azabu Buildings Co. Ltd.'s Answer to Complaint to Foreclose Mortgages Filed on October 4, 1993, and Counterclaim, at 4–14, The Mitsui Trust & Banking Co., Ltd. v. Azabu Buildings Co., Ltd. (No. 93-3846-09).

269. *Id.* at 14.

270. Dokusen kinshi hō dai 45 jō dai 1 kō ni motozuku shinkoku [Petition Based on Article 45, Paragraph 1 of the Law Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade], April 22, 1994, at 4.

271. For an overview of the cases, see *Tokushū: Kin'yū torihiki to setsumei gimu [Special Edition: Financial Transactions and the Duty to Explain]*, 1407 KIN'YŪ HŌMU JIJŌ 6 (1995).

272. Impact loans are made in yen, but repaid in a specified foreign currency. One survey of small firms for the years 1982–1984 found that 60% of all impact loans were made on the initiative of the main bank. Horiuchi, *supra* note 175, at 269.

had failed to adequately inform them of the risks.[273] In another line of cases, individuals have filed a large number of lawsuits against banks and insurance companies that aggressively marketed variable life insurance policies to the wealthy as a riskless estate tax planning device in the late 1980s. The investment value of the policies vanished with the decline in the stock market, leaving the insureds without funds to repay substantial bank loans used for the insurance premiums.[274]

These suits all closely track the relational pattern. Small firms, troubled firms operating outside the usual conventions of Japanese business, and individuals have tenuous ties to the banks. In each of these cases, economic pressures stressed a relationship, and the relationship proved inadequate to constrain bank withdrawal or opportunism; it also proved insufficient to restrain the customer's resort to litigation. The *Azabu* case in particular presents a prime example of traditional Japanese banking practices that, in a new economic and social environment, are now being played out in a highly legalistic manner.

2. Shareholder-Manager Relations: Derivative Litigation

The shareholder-manager relationship is also showing signs of change. This is evidenced by a striking increase in the number of derivative actions filed in the past few years. The current derivative suit mechanism was introduced by the Occupation reformers in 1950. Twenty-seven derivative actions were publicly reported in the forty years between 1950 and 1990.[275] By contrast, at least twenty-three derivative actions were filed from 1991 to 1994.[276] The amount of damages

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273. *See, e.g.*, Judgment of Jan. 29, 1987 (Ban Kōgyō K.K. v. Sanwa Ginkō K.K.), Osaka Chisai [Osaka District Court], 1149 KIN'YŪ HŌMU JIJŌ 44 (holding for borrower on ground that bank had breached the duty of good faith by inadequately explaining the characteristics and risks of impact loans to company whose business was entirely domestic); Judgment of June 26, 1992 (Kyō K.K. v. Sanwa Ginkō K.K.), Tokyo Chisai [Tokyo District Court], 1333 KIN'YŪ HŌMU JIJŌ 43 (1992) (holding for bank on ground that borrower was well informed of risks).

274. For an overview of the cases, see Toshiaki Hasegawa, *Baburu keizai no atoshimatsu? [Bubble Economy Cleanup?]*, 552 NBL 13, 13–15 (1994). The most unsettling decision for financial institutions to date is a 300 million yen (about $3 million) judgment rendered against Meiji Mutual Life Insurance Co. for premiums and interest, for failing to explain the risks related to the policy and for conveying misleading information to the policyholder. Judgment of May 30, 1994 (Ikeda v. Meiji Life Insurance Mutual Corp., or The Meiji Life Case), Tokyo Chisai [Tokyo District Court], 1390 KIN'YŪ HŌMU JIJŌ 39. Over 200 similar cases were pending in Tokyo District Court as of June 1994. *Judge Orders Insurer to Pay 308 Million Yen for Client's Losses*, NIKKEI WKLY., June 20, 1994, at 17, *available in* LEXIS, World Library, Allwld File. Banks are often named as defendants in these cases because they jointly market the insurance policies and lend the funds for the large lump-sum premium payments required to purchase the policies.

275. *See Roundtable*, *supra* note 92, at 41–45 (table listing all major derivative actions reported between 1950 and 1994).

276. *See id.* Press reports indicate that 84 suits were pending as of the end of 1993. Masayuki Tamura & Toyoki Sakata, *Shareholders Turning to Lawsuits to Assure Executive Accountability*, NIKKEI WKLY., May 9, 1994, at 1, *available in* LEXIS, World Library, Allwld File.

sought by plaintiff-shareholders has also skyrocketed. As recently as the 1980s, derivative plaintiffs typically sought damages measured in the hundreds of millions of yen, peaking at 750 million yen in a suit filed in 1988.[277] It is now commonplace for plaintiffs to seek billions of yen (tens of millions of dollars) in damages. A suit filed against two directors of Japan Airlines in 1994 seeks well over a trillion yen (over $10 billion) in damages.[278] Perhaps more telling than the increase in the raw number of suits filed or the amount of damages sought is the climate of fear engendered among Japanese management by a 1993 amendment to the Commercial Code that substantially lowered the cost of initiating derivative actions.[279] One prominent Japanese commentator likens the Commercial Code amendments to lighting the wick on an arsenal that has just been filled with explosives.[280]

It is tempting to explain the increase in derivative actions principally as the result of altered economic calculus for potential plaintiffs.[281] To be sure, substantial filing fees could serve as insurmountable barriers to derivative litigation under the pre-amendment system,[282] and as noted above, shareholders are making dramatically larger damage claims. Thus, the Commercial Code amendments lower the cost of

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277. *Roundtable*, *supra* note 92, at 43. Judgment of May 2, 1990 (Receiver in Bankruptcy for Kosmoporitan K.K. v. Sumitomo Ginkō K.K. et al.), Osaka Chisai [Osaka District Court], 74 SHIRYŌBAN SHŌJI HŌMU 65.

278. *See Roundtable*, *supra* note 92, at 45. *Cf.* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (ultimately settled for $23.5 million; helped touch off a liability crisis in U.S. boardrooms in the latter half of the 1980s).

279. Largely at the urging of the United States in the Structural Impediments Initiative, the Commercial Code was substantially revised in 1993. The amendments were designed in large measure to facilitate derivative actions. The amendments lowered the threshold percentage of stock ownership required to inspect corporate books from 10% to 3%, COMMERCIAL CODE art. 293-6, allowed greater recovery of out-of-pocket and other expenses incurred in litigating a derivative suit, COMMERCIAL CODE art. 268-2 and, most importantly, fixed at 8200 yen (about $82) the filing fee required to initiate a derivative suit. COMMERCIAL CODE, art. 267(4). On the concern that these amendments engendered among Japanese managers, see Masayuki Tamura & Toyoki Sakata, *Shareholders Turning to Lawsuits to Assure Executive Accountability*, NIKKEI WKLY., May 9, 1994, at 1, *available in* LEXIS, World Library, Allwld File.

280. Ichirō Kawamoto, *Hōteki kankyō no henka to kabushiki kaisha keiei* [*The Changing Legal Environment and Corporate Management*], 104 SHIHON SHIJŌ 57, 58 (1994).

281. *See, e.g.*, West, *supra* note 60, at 1493–1507.

282. A now infamous example of cost barriers to litigation is a shareholder derivative suit brought against the directors of Nikko Securities Co. alleging breaches of duty in the payment of rebates to clients for stock market losses. The Tokyo District Court dismissed the suit when the plaintiffs refused to pay a filing fee of over 235 million yen (about $2.4 million) that the court determined was due before the suit could go forward. Judgment of Aug. 11, 1992 (Asai v. Iwasaki, or The Nikkō Case), Tokyo Chisai [Tokyo District Court], 797 HANTA 285. The lower court's decision was reversed on appeal, however, on the ground that the amount of damages sought in a derivative suit is indeterminate, implicating a code provision that sets the fee in such cases at 8200 yen. Judgment of Mar. 30, 1993, Tokyo Kōsai [Tokyo High Court], 1460 HANJI 138, *aff'd* Judgment of March 10, 1994, Saikōsai [Supreme Court], 121 SHIRYŌBAN SHŌJI HŌMU 149 (1994). The 1993 amendment to the Commercial Code essentially codifies the High Court's decision in *Nikko*.

suing, while larger damage claims increase the potential gains from suing, at least for plaintiffs' attorneys.

But the reasons for increased use of the derivative suit mechanism may be more complex. In U.S. corporate law theory, derivative litigation to enforce director liability rules is one of the mechanisms by which shareholders constrain management opportunism and minimize the agency costs inherent in the separation of ownership and control. Unlike certain other corporate governance mechanisms that involve monitoring ex ante, enforcement of the fiduciary duties of management requires litigation ex post to penalize undesirable management conduct.[283] Increased ex post monitoring in Japan may reflect not only reduced enforcement costs, but a need to adapt governance mechanisms to changing environments. The increase in derivative litigation is consistent with more arm's length relationships among Japanese managers and at least some of their shareholders, corresponding to a heavier reliance on capital market finance. Ex post judicial enforcement of liability rules may be the sole recourse for those shareholders whose other linkages to management are insufficient to permit alternative forms of monitoring. Moreover, the spate of financial scandals and speculative business practices that came to a head during Japan's bubble economy indicate that bank-centered monitoring may not work well in an easy money environment, because a clear conflict arises between the financing and ex ante monitoring functions of the bank. In much the same way, the expansion of financing alternatives accompanying deregulation, which places competitive pressure on the banks, may also be inconsistent with main bank monitoring incentives.

If there is a link between corporate governance and economic efficiency,[284] when existing monitoring mechanisms lose effectiveness, alternatives must be found in order for corporations to remain competitive. The rise of the derivative suit may therefore reflect an evolution in Japanese monitoring mechanisms and the shareholder-manager relationship it was designed to govern.

3. Government-Business Relations: Procedural and Institutional Integrity

A new emphasis on procedural formality in administrative affairs and heightened governmental enforcement efforts challenge the long history of consensual economic management between regulators and the regulated.

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283. Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1420 (1989).

284. For a thoughtful discussion of this issue in comparative perspective, see Gilson, *supra* note 22.

a. Administrative Procedure Law

As Japan's economy matured and internationalized, the benefits of administrative informality began to be overshadowed by its drawbacks.[285] A series of financial scandals in the early 1990s for the first time openly called into question both the wisdom and fairness of bureaucratic policies and procedures.[286] The degree of trust in the Japanese bureaucracy was diminished[287] and a long-held fear that heavy use of administrative guidance undermines the rule of law in Japan resurfaced.[288]

It is no coincidence that in 1993, shortly following these financial scandals, the Diet enacted an Administrative Procedure Law (APL)[289] after almost thirty years of inconclusive government study. The APL's stated purpose is to increase the uniformity, fairness, and transparency of Japanese administrative processes.[290] The most important aspects of the law are provisions circumscribing administrative guidance and specifying procedures to be followed by agencies in dealing with administrative applications. The APL attempts to circumscribe the use of administrative guidance by reminding bureaucrats that they must not exceed "in the slightest degree" the scope of their jurisdiction, and that cooperation of the party subject to administrative guidance is

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285. *See, e.g.*, ECONOMIC REFORM STUDY COUNCIL, *supra* note 230, at 1; Mabuchi, *supra* note 184, at 130 (arguing that deregulation and internationalization forced clarification of regulatory activities).

286. The public outpouring of consternation at MOF and the *modus operandi* of the entire Japanese bureaucracy following the financial scandals is quite extraordinary. The titles of these works alone vividly convey the sentiment of their authors. *See, e.g.*, Akio Horiuchi, *Shōken shijō no kōsei kakuritsu: ōkurashō de wa fukanō* [*Ensuring Fairness in the Securities Market through the Ministry of Finance is Impossible*], EKONOMISUTO, Aug. 27, 1991, at 12; Naoki Tanaka, *Revealing the Flaws in the Regulatory Tradition*, JAPAN ECHO, no. 4, 1991, at 10 (1991); Tatsuo Uemura, *Shōtorihō no kaishakuken wo ōkurashō kara torimodose* [*Take Back the Right to Interpret the Securities and Exchange Law from the Ministry of Finance*], EKONOMISUTO, Sept. 17, 1991, at 20. In addition to public loss of confidence in the regulators, the securities industry distanced itself from MOF following what it viewed as MOF's "betrayal" of the industry in its handling of the financial problems. Milhaupt, *supra* note 95, at 452 n.129.

287. Trust is a key variable in moving along the discrete-relational spectrum in regulatory matters. MACNEIL, *supra* note 133, at 68 ("Lawyers often forget that imposed procedural regularity is needed and useful only when good faith and trust decline below certain levels.").

288. RINJI GYŌSEI KAIKAKU SUISHIN SHINGIKAI [AD HOC COUNCIL ON THE PROMOTION OF ADMINISTRATIVE REFORM], KŌSEI, TŌMEI NA GYŌSEI TETSUZUKI HŌSEI NI KANSURU TŌSHIN [REPORT ON THE PREPARATION OF LEGISLATION FOR FAIR, TRANSPARENT ADMINISTRATIVE PROCEDURES] (Dec. 12, 1991). Scholars have long argued that Japan's administrative practices undermine democratic impulses in the legal system. *See* Hideo Tanaka & Akio Takeuchi, *The Role of Private Persons in the Enforcement of Law: A Comparative Study of Japanese and American Law*, 7 LAW IN JAPAN 34 (1974) (arguing that virtual monopoly on law enforcement by public officials does damage to democracy in the legal system).

289. Gyōsei tetsuzukihō [Administrative Procedure Law], Law No. 88 of 1993 [hereinafter APL]. For background on the domestic and international forces that led to passage of the APL, see David Boling, *Administrative Procedure Law Makes Inroads on Bureaucracy but Leaves Web Largely Intact*, E. ASIAN EXECUTIVE REP., July 15, 1994, at 7.

290. APL art. 1(1).

voluntary.[291] Regulators are expressly prohibited from punishing parties for noncompliance with administrative guidance,[292] a favored tactic of the economic ministries.[293] The APL attempts to increase transparency by requiring that regulators put their guidance in writing at the request of the recipient[294] and state the purposes of their guidance.[295] The APL also requires that agencies enact and make public formal standards for processing applications[296] and establishes a formal hearing procedure for parties adversely affected by administrative determinations.[297]

The APL represents a significant, if partial shift toward the discrete end of the regulatory contracting spectrum.[298] Enhanced transparency and standardization of administrative procedures increase the accountability of bureaucrats and formalize to a degree a previously ad hoc, flexible, and opaque system of regulation. In so doing, the APL increases the elements of discreteness and "presentiation" in bureaucratic output.[299] Although substantial disincentives to utilizing the formal procedures of the APL remain for regulators, the agency in charge of drafting and administering the statute is urging businessmen to police bureaucratic compliance with the new law so that agencies cannot punish those who seek to hold regulators to the dictates of the statute.[300]

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291. *Id.* art. 32(1).

292. *Id.* art. 32(2).

293. For an account of the most celebrated use of collateral punishment to coerce compliance with "voluntary" guidance, see UPHAM, *supra* note 135, at 176–84 (describing Ministry of International Trade and Industry's threat to limit recalcitrant company's import quota of coal in order to coerce compliance with an informal production cartel in steel industry).

294. APL art. 35(2). An exception is made if reducing administrative guidance to writing would cause "extraordinary administrative inconvenience." *Id.*

295. *Id.* art. 35(1).

296. *See id.* arts. 5–11.

297. *Id.* arts. 15–31.

298. The degree to which the APL represents fundamental change in administrative practices should not be exaggerated. In some respects, it is a classic example of Japanese legislation: long on heuristics and short on binding obligations and formal enforcement mechanisms. The drafters' frequent resort to qualifying or hortatory language leaves substantial room for bureaucratic maneuvering. *See, e.g.*, APL art. 5(2) (administrative agencies shall make review standards "as concrete as possible"); art. 6 (agencies "shall endeavor" to establish standard time periods for dealing with applications). Perhaps the best example of this approach to legislation is Japan's Equal Employment Opportunity Law, which exhorts employers to "endeavor" to provide equal opportunity to women in the areas of recruitment, hiring, assignment, and promotion. Danjo koyō kikai kintōhō [Equal Employment Opportunity Law], Law No. 45 of 1985, arts. 7–8.

299. *Cf.* MACNEIL, *supra* note 133, at 77. Presentiation is Macneil's term for the ability to precisely define future conditions, obligations and entitlements at the inception of a transaction. *See* Macneil, *supra* note 21, at 863.

300. *Japan: New Business Administrative Law*, 1995 NATIONAL TRADE DATA BANK MARKET REPORTS, Mar. 21, 1995, *available in* LEXIS, Asiapc Library, Busanl File.

b. Securities and Exchange Surveillance Commission

Even the Ministry of Finance, whose past regulatory activity has epitomized relational contracting with the parties under its jurisdiction, is adapting institutionally to the new environment. In the wake of the financial scandals discussed above, a new agency was created within MOF to monitor the securities markets and to inspect securities firms and exchanges.[301] The Securities and Exchange Surveillance Commission [*Shōken torihikitō kanshi iinkai*] as the agency is known, is an institutional outgrowth of the perceived need for more arm's length relations between the securities industry and its regulators.[302] In its first three years of existence, the SESC has sought criminal charges in five cases, inspected almost three hundred securities companies and other financial institutions, and investigated hundreds of securities transactions.[303] The criminal cases separately involve insider trading, market manipulation, and misleading financial disclosure.[304] The selection of cases for prosecution appears calculated to convey the SESC's determination to police the principal areas of criminal conduct under the securities laws. In spite of these enforcement efforts, the SESC's tenuous organizational independence as an arm of MOF renders it susceptible to charges of weakness and understaffing.[305] Nonetheless, the SESC's activities must be evaluated in the context of the preceding four decades of Japanese securities regulation, during which MOF engaged in virtually no formal market monitoring or enforcement activity. Thus, while it is too early to predict the SESC's ultimate success or failure, its establishment constitutes a concrete attempt to reorient Japanese securities regulation toward identifiable regulatory standards and enforcement grounded in formal law.

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301. For an analysis of the agency's establishment, powers, and independence, see Milhaupt, *supra* note 95, at 460–76.

302. *See* RINJI GYŌSEI KAIKAKU SUISHIN SHINGIKAI [AD HOC COUNCIL ON THE PROMOTION OF ADMINISTRATIVE REFORM], SHŌKEN, KIN'YŪ NO FUKŌSEITORIHIKI NO KIHONTEKI ZESEISAKU NI KANSURU TŌSHIN [REPORT ON FUNDAMENTAL MEASURES TO CORRECT UNFAIR SECURITIES AND FINANCIAL TRANSACTIONS] (Sept. 13, 1991), *reprinted in* 989 JURISUTO 50 (1991) (identifying protective, nurturing quality of MOF's securities regulation and opacity of rules due to heavy reliance on administrative guidance as key factors contributing to the financial scandals; proposing creation of new capital market oversight agency).

303. Hiroaki Hoshino, *Shōken torihikitō kanshi iinkai no katsudō jōkyō* [*Activities of the Securities and Exchange Surveillance Commission*], 1404 SHŌJI HŌMU 2, 6 (1995).

304. The five cases include the successful prosecutions of multiple defendants in one stock manipulation case and one insider trading case, and pending criminal charges in three cases involving the falsification of financial statements submitted to MOF, insider trading, and market manipulation, respectively. *See, e.g.*, Judgment of Oct. 3, 1994, (The Nihon Unisys Case), Tokyo Chisai [Tokyo District Court] 128 SHIRYŌBAN SHŌJI HŌMU 166 (1994).

305. *See* Steven Brull, *Japanese Panel Brings Insider Charges*, INT'L HERALD TRIB., Oct. 15, 1994, *available in* LEXIS, World Library, IHT File.

4. Employment Relations: Layoffs and Litigation

Scholars and economists view the changes in Japanese employment practices not simply as the result of cyclical trends, but as a consequence of the structural hollowing out of industry. Thus, the postwar vision of the Japanese firm as being run for the sake of the employees is being severely tested.[306] As the lifetime employment system weakens and companies begin resorting to layoffs and other involuntary dismissals, employees are increasingly responding with litigation.[307] A recent survey by the Japanese Supreme Court shows that almost four thousand lawsuits concerning labor disputes were filed in fiscal 1994, the second highest number in postwar history.[308] Almost all of the suits were brought by individuals against their employers, and 340 suits involved dismissals or transfers.[309]

5. Corporate-Consumer Relations: Product Liability

Informal, extra-judicial mechanisms frame the traditional Japanese approach to corporate Japan's relations with consumers. Until recently, the principal legal framework for defective products was provided by century-old contract and tort provisions of the Civil Code.[310] Since substantial obstacles to recovery existed under this regime,[311] an extensive network of administrative compensation plans, product testing requirements, industry-funded insurance schemes, and consumer consultation centers was developed to address product liability issues. The result was a heavily administered, largely informal interface between manufacturers and consumers, and a comparative dearth of product liability litigation.[312]

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306. Egashira, *supra* note 94, at 3.

307. *See, e.g.*, Judgment of August 30, 1994 (Ōsugi v. Yachio Denshi K.K.), Tokyo Chisai [Tokyo District Court], RŌDŌ KEIZAI HANREI SOKUHŌ no. 1538, Oct. 10, 1994, at 3 (unsuccessful suit by an employee who was dismissed on grounds of incompatibility with and inferiority to other workers in second round of layoffs following recession-induced corporate reorganization); *The Employees Strike Back: Workers Challenging Layoffs, Dismissals—And Winning*, NIKKEI WKLY., Aug. 15, 1994, *available in* LEXIS, World Library, Allwld File (reporting significant increase in employment litigation, and settlements after threat of legal action).

308. *Restructuring Leads to Drastic Increase in Labor Suits*, Japan Economic Newswire, Oct. 29, 1995, *available in* LEXIS, News Library, JEN File.

309. *Id.*

310. Under Japan's Civil Code, consumers can seek recovery for damages caused by defective products under contract or tort theory. *See* CIVIL CODE art. 415 (contract) and art. 709 (tort).

311. Claims based on contract are limited by a privity requirement and a fault requirement, as is consistent with civil obligation law theory. Claims based on tort are similarly hampered by a fault requirement, as well as difficulties in proving causation.

312. Eighty-one product liability cases were decided by the courts from the inception of the code-based legal system in the late 19th century to 1986. SEIZŌBUTSU SEKININ WO MEGURU SAIKIN NO UGOKI [RECENT DEVELOPMENTS IN PRODUCT LIABILITY], (KEIZAI KIKAKUCHŌ KOKUMIN SEIKATSUKYOKU SHŌHI GYŌSEI DAI-IKKA [FIRST CONSUMER ADMINISTRATION SEC-

A Product Liability Law[313] passed in 1994 attempts to bolster the position of consumers by lowering obstacles to recovery.[314] Although the law has only been in effect since mid-1995, governance mechanisms are already evolving to meet the heightened risk of litigation. Manufacturers are already altering their product lines[315] and internal organizational structures[316] in response to the legislation.

6. Legal Risk: Use of Attorneys

Professor Ronald Gilson has argued that business lawyers in the United States create value by facilitating private ordering in their role as "transaction cost engineers."[317] He concludes that lawyers are the principal architects of the "elaborate formal transactional structure" that constrains uncertainty-based opportunism in a large, heterogeneous society like the United States.[318] From this analytical perspective, Gilson was able to view the perennial and highly misleading comparisons between the number of lawyers in Japan and the United States in a new light. He convincingly argues that if business lawyers do not serve as the principal constraints on opportunism in Japan, numerical comparisons are flawed. Lawyers in the United States must instead be compared with the mechanisms, such as the lifetime employment system, which serve to constrain opportunism in Japan.[319]

If Gilson's analysis is accurate, then an increase in the number of lawyers and the frequency of resort to their services in business contexts would suggest that these alternative opportunism-constraining mechanisms are breaking down. In fact, there are indications that, due to the developments discussed in this part, legal assistance is becoming more important to Japanese companies. Legal departments of corporations

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TION, CITIZEN'S LIFE BUREAU, ECONOMIC PLANNING AGENCY] ed., 1987). By contrast, claimants in the United States file 13,000 product liability cases annually in the U.S. federal courts alone. W. Kip Viscusi, *The Dimensions of the Product Liability Crisis*, 20 J. LEGAL STUD. 147, 151 (1991). Even if, as is surely the case, only a fraction of these suits are litigated through to a judgment, the contrast with Japan is stark.

313. Seizōbutsu sekininhō [Product Liability Law], Law No. 85 of 1994.

314. The law simply requires that manufacturers compensate users injured by defective products. *Id.* art. 3. "Defect" is defined so that, subject to certain exceptions, plaintiffs recover if they prove that the product lacked normal safety. *Id.* art. 2.

315. *See, e.g.*, *Mitsubishi to Trim Product Line for Sake of Bottom Line*, COMLINE Daily News Tokyo Financial Wire, July 18, 1994, *available in* LEXIS, News Library, Curnws File (reporting that Mitsubishi plans to discontinue certain product lines to reduce product liability risk created by new law).

316. *See, e.g.*, *Manufacturers Brace for Product Liability Law*, Jiji Press, Apr. 12, 1994, *available in* LEXIS, News Library, Non-US file (reporting that Matsushita Electronics and Toshiba have created Product Safety Departments in response to the law).

317. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

318. *Id.* at 306–13.

319. *Id.* at 308–09.

and financial institutions are expanding rapidly in Japan.[320] By all accounts, the expansion is a response to a business climate of heightened legal risk.[321] Virtually every Japanese bank surveyed in a 1994 study cited managing legal risk, preventive law, or monitoring the legality of management decisions as the function of their legal section that most needed strengthening.[322] Preventive law and adept management of legal risk are now viewed by some observers as essential competitive tools for Japanese financial institutions and other corporations.[323] For one prominent Japanese legal scholar, the newfound recognition of the role of corporate legal departments reflects both a past underappreciation of law's importance and the increasing role of law in structuring the activities of Japanese citizens and institutions in this new environment.[324]

V. CONCLUSION

Viewed in relational perspective, legal rules and institutions play a more significant role in enforcing the Japanese corporate contract than previously thought. While the Japanese firm has traditionally deviated substantially from the dictates of the corporate and securities laws designed to govern corporate organization and monitoring, other facets of the legal system have encouraged or compelled a highly cooperative environment that facilitates relational governance. Whether in forcing parties into long-term interaction by blocking exit from relationships, encouraging and structuring private ordering, or casting a shadow in which to bargain, legal rules and institutions have always formed a critical part of the nexus of corporate constraints in Japan.

Yet even as we begin to perceive more clearly the Japanese firm and the environment in which it operates, both are in flux. As a previously insular and rapidly growing economy is overtaken by international competitive and regulatory pressures and slowed by prolonged reces-

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320. Mihoko Iida, *Japan: Demand Soaring for Legal Experts—Corporations Bolster Legal Departments, But Lawyers Still Rare*, NIKKEI WKLY., July 19, 1993, *available in* LEXIS, World Library, Allwld File.

321. *See, e.g.*, Kawamoto, *supra* note 280, at 58. Commentary on one recent survey of bank legal departments concludes that "if [Japanese] banks become involved in hundreds of lawsuits as happens in the United States, of necessity the age of the 'mega legal department' will probably have arrived. In fact, we seem to be heading in that direction." *Survey of Legal Sections*, *supra* note 212, at 77.

322. *Survey of Legal Sections*, *supra* note 212, at 79–91.

323. *See Kin'yū kikan hōmu sekushon e no teigen* [*Proposals for Legal Sections of Financial Institutions*], 1375 KIN'YŪ HŌMU JIJŌ 63 (1994).

324. *Id.* at 66–67 (remarks of Professor Hideki Kanda). *See also Sukunai? Ōi?: Nihon no bengoshi* [*Japanese Lawyers: Too Few? Too Many?*], ASAHI SHIMBUN, Dec. 18, 1994, at 3 (reporting that many Japanese predict that more legal professionals will be needed in the future because the passage of the APL, product liability law, and derivative suit amendments signify a social trend toward "legal resolution" of issues).

sion, relationships among parties to the Japanese corporate contract increasingly take on arm's length qualities. Consequently, formal legal rules and procedures increasingly appear to be playing the roles traditionally occupied by long-term cooperation. The role of law in Japanese corporate governance may be changing from a meta-framework for corporate cooperation to a more direct means of channeling conduct and settling disputes ex post. If the Japanese example confirms that corporate governance mechanisms are path dependent, it also demonstrates that they are continually in flux.

Indeed, the balance of constraints on both Japanese and American corporations appears to be shifting. In Japan the shift is a consequence of the erosion and replacement of existing institutions and business practices in response to domestic and international forces. An increased resort to legal remedies furthers this shift, affecting the structure of corporate organization, monitoring, and discipline. Conversely, U.S. firms and investors increasingly recognize the benefits of relational investing[325] in contrast to the expense and adverse consequences of a court-centered approach to corporate governance.

The Japanese and American systems of corporate governance have wandered down separate paths in spite of many similarities in the legal framework for corporate and securities activities; there is some evidence suggesting that those paths are now beginning to converge, if only at the margins. The point is not that Japan is necessarily moving toward the U.S. model of corporate governance. Rather, the points are twofold. First, the interplay between law, social norms, markets, and institutions in the governance of the Japanese firm is even more complex and dynamic than previous explanations suggest. Second, law matters, even in the cooperative world of Japanese corporate governance.

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325. *See, e.g.*, Ian Ayres & Peter Crampton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033 (1994); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994).