IDEAS, POWER AND EFFICIENCY: THE TRANSFORMATION OF JAPANESE CORPORATE LEGISLATION, 1974-2006

by

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Dissertation submitted in partial fulfillment of
the requirements for the degree of Doctor
of Philosophy in the Department of
Sociology in the Graduate School
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2008

ABSTRACT

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Abstract

The purpose of this project is to explain the transformation of Japanese corporate law in the last three decades. The data is collected in the field study in Japan between May 2005 and June 2006. This project shows that the chaning dominant policy paradigm that defines the nature of a corporation and its relationship with the society in the policy field has indispensable impact on corporate legislation. Before the mid 1990s Japanese corporate legislation was dominated by bureaucrats in Ministry of Justice and the community of law scholars; they saw a corporation as a special association that has profound impacts on social order. The economic crisis in 1990 and the diffusion of the U.S. economic thinking among young generation of economic bureaucrats led to the regime shift of corporate legislation. After 1997, corporate legislation was dominated by economic bureaucrats who saw a corporation as a nexus of contracts whose only relationship with society is producing wealth. This shift significantly changed the course of corporate legislation.

First, the paradigm shift brought different regulatory schemes for corporate finance. Before the mid 1997, corporate finance was seen as a source of turbulence and was strongly restrained. After the paradigm shift in 1997, corporate finance was perceived as a positive way to raise shareholder value by economic bureaucrats. Therefore, the course of legislation shifted to substantial deregulation. Second, the paradigm shift also brought significant change to the regulations for governance structure. Before 1997, a corporation was seen as an association composed of stable

shareholders. Therefore, the solution to managerial misconducts was to strengthen internal democracy. After 1997 because the perception of a corporation had shifted to a nexus of contracts that are constantly negotiated in financial markets, the solutions to managerial misconducts were to strengthen board independence and information disclosure. Third, before 1997 corporate restructuring was seen as an important event that entails complicated procedural requirements to protect shareholders and creditors. After 1997 because corporate restructuring was treated as a tool to enhance economic efficiency by economic bureaucrats, a variety of restructuring schemes were deregulated.

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Glossary of Legal Terminology

Term	Definition
Legal personality 法人	The corporation's independent legal status from the various individuals who own or manage it
Limited liability 有限責任	The principle that the creditors are limited to making claims against the assets that are owned by the firm, and have no further claims against the firm's shareholders or managers
Transferable share 譲渡性	The principle that the change of owners does not influence the corporation's legal status and the legal affects of its behavior
Investor Ownership 出資者所有権	Shareholders' rights of receiving the corporation's net earnings and of controlling the corporation.
Board of Directors 取締役会	The group of persons chosen to govern the affairs of a corporation or other large institution
Board of Auditors 監査役会	The group of persons chosen to monitor the executive branch
Regular Auditor 常勤監査役	Full Time Corporate Auditors
General Meeting of Shareholders 株主総会	The annual meeting of all shareholders. This meeting is supposed to be the highest organ in the corporation.
Jiekiken(No equivalent term in English)自益権	Shareholders' right of seeking personal interest in a corporation, generally refers to the rights of receiving dividends and financial benefits
Kyōekiken (No equivalent term in English) 共益権	Shareholders' right of seeking collective interest in a corporation, generally refers to the rights of participating in important decision
Shareholders' right of receiving equal treatment 株主平等原則	Each share in a corporation should own the same rights and interests

Principle of sufficient capital (充実資本原則	The principle that corporations should maintain a certain amount of capital to protect the creditors
Authorized capital 授権資本	The number of shares of capital stock that a corporation may issue. The number of shares authorized often greatly exceeds the number actually issued.
Preemptive Right 新株引受権	A privilege given to an existing shareholder to buy a portion of a new stock issue at the offering price on a pro-rata per-share basis.
Call Option 新株予約権	A financial contract between two parties, the buyer and the seller of this type of option. The buyer of the option has the right, but not the obligation to buy an agreed quantity of a particular commodity or financial instrument from the seller of the option at a certain time for a certain price. The seller is obligated to sell the commodity or financial instrument
Convertible Bond 転換社債	A bond that can be exchanged for a fixed number of shares of the common stock of the issuing company at the holder's option
Warrant Bond 新株引受権付社債	A bond that attaches a security that entitles the holder to buy stock of the company that issued it at a specified price.
Share Repurchase 自己株式取得	A program by which a company buys back its own shares from the marketplace, reducing the number of outstanding shares.
M&A (Merger & Acquisition) 企業合併買取	The consolidation of companies. A merger is a combination of two companies to form a new company while an acquisition is the purchasing of one company by another with no new company being formed.
Triangular Merger 三角合併	A merger in which the acquiring corporation forms a new subsidiary into which the target corporation is merged.
The Right to Supervise 業務監査権	The right to supervise the executive affairs
Shareholders' Proposal Right 株主提案権	Shareholders' right to raise proposal in the general meeting of shareholders

Shareholders' Question Right 株主質問権	Shareholders' right to question directors in the general meeting of shareholders
Shareholder Derivative Lawsuit 株主代表訴訟	A lawsuit instigated by a shareholder of a corporation, not on the shareholder's own behalf, but on behalf of the corporation. Often derivative suits are brought against officers or directors of a corporation for violations of fiduciary duties owed to the shareholders vis-a-vis the corporation.
Minimal Capitalization 最小資本金	Initial funds a limited liability corporation is required to have
Company with Committee 委員会設置会社	Corporations that abolish tow tier board and
Corporate Chapter 定款	The chapter formed during incorporation that defines the capital, shares, incorporators, governance structure and other important issues.
Shareholding Company 持株会社	A corporation whose whole purpose is controlling subsidiary companies through shareholding

Glossary of Abbreviations

MITI	Tsūshōsangyōshō (通商産業省)、 Ministry of International Trade and Industry
METI	Keizaisangyōshō (経済産業省) Ministry of Economy, Trade and Industry (Formed in 2001)
MOJ	Hōmushō (法務省) Ministry of Justice
MOF	Before 2001, Okurashō 大蔵省,after 2001, Zaimushō 財務省 Ministry of Finance
GHQ	General Headquarters
HOR	Shugiin 衆議員 House of Representative
HOC	Sangiin 参議院 House of Chancellor
Keidanren	Keizai Dantai Rengokai（経済団体連合会）, Before 2002, Japan Federation of Economic Organization; after 2002, Japan Business Federation
LDP	Jiyūminshutō　自由民主党 Liberal Democratic Party

Ch 1 Introduction

1.1 Koizumi Reform and Its Implications

Since the late 1970s, the seemingly irresistible competitiveness inspired attentions to Japan's unique mode of corporate governance. Japanese corporations were often praised for their ability to establish long term competitiveness and protect job security (Calder, 1995; Dore, 1998). Japan's outstanding economic performance was widely cited as the evidence supporting alternative mode of capitalism and socially embedded economy (Dore, 1973; Aoki, 1988; Aoki & Dore, 1996; Dore, 1996). However, in the 1990s as Japan faced economic stagnant, the focus shifted from the strength to the weakness of the Japanese system. Many insist that the only way Japanese economy can recover is to radically transform its institutions and converge on a more market oriented model (Katz, 1998; 2001; Lincoln, 2001; Anchordoguy, 2005).

The rise of Koizumi Junichirō, a unconventional LDP politician, marked the zenith of this movement of structural reform. His compain slogan "no reform, no growth" gain great support from the Japanese voters who suffered from long-term recession and defeat his oppoenent who was suppoted by all major factions of LDP in 2001. It is widely believed that Koizumi brought a revolutionary change for Japanese politics. He pledged to break the notorious factional politics that dominated Japan for half a century and proposed neoliberal reforms that prioritized market mechanism in a variety of fields of public policy. In the political field, Koizumi successfully transformed the process of policy making in Japan. Using his popularity, he challenged the traditional factional negotiation and rejected vested interests, which are often the major constitencies of LDP.

In the economic field, he radically deregulated restrains on private sectors, privatized public enterprises and tried to strengthen the role market in Japan's economy. When he stepped down in 2006, he remained one of the most popular prime ministers in postwar Japan (Uchiyama 2007).

Corporate legislative reform was among the most ambitious components of Koizumi's reform projects. Its target was not the Japanese government but the Japanese corporations. In year 2005 Japanese Diet (congress) passed a comprehensive reform package to renew the corporate law. This package deregulated the restrains on corporate finance, encouraged market for corporate control, and allowed a more flexible governance structures (Kanda 2006; Dore, 2006; Tiberghien, 2007). This reform package contradicted with many parts of the traditional Japanese model of corporations and provided the legal environment that allows corporations to adopt the Anglo-Saxon model of corporate governance.

This dramatic change brings an important question: why Japan adopted a market oriented reform on corporate law? This question has important implication for not only the field of Japanese studies but also for economic sociology. Given the significance of large corporations in contemporary global economy, corporate governance has become a salient issue for sociologists (Davis 2005; Fligstein and Choo 2005). Corporate law is an important factor influencing corporate governance. Corporate law serves two functions in corporate governance: establishing the basic structures of the corporate form and ancillary rules, and defining the legal relationships among corporate constituencies,

including controlling shareholders, minority shareholders, top managers, and creditors. As economic sociologists insist that corporate governance is embedded in social structures, corporate legislation, which is part of this "embeddedness," should be taken more seriously. Noticing the significance of law in economic activities, Swedberg (2004) and other economic sociologists recently has called for an economic sociology of law. Davis (2005) also suggested that analyzing corporate governance in terms of the dynamics of institutions—where they originate, how they operate, how they change, and how they spread beyond their original purposes—will be a promising enterprise for sociologists. From this angle, the Japanese corproate legislative reform affords a strategic site to advance the economic sociology of law.

This case also has significant implications for the sociology of globalization. One of the most important ongoing issues in the social sciences is the relationship between global economy and national institutions. The traditional wisdom of comparative political economy rejects the claim that diverse political economies are converging on one single model and insists the persistence of diverse national institutions (Hall and Soskice, 2001; Berger and Dore, 1996; Kitschelt et al., 1999). However, recently increasing empirical studies found that neoliberalism that prioritizes market as the main mechanism governing the economy and public policy has prevailed worldwide. Many begin to raise the question about the causes and limitation of the current institutional change (Campbell and Pedersen 2001; Yamamura and Streeck 2003; Streeck and Thelen 2005). The Japanese corporate legislative reform is among the most important cases of

this worldwide phenomenon. Through incremental changes, Japanese economic system has significantly shifted from the traditional model to a more market oriented system and the Koizumi reform marked the zenith of this transformation. (Hiwatari and Miura, 2002; Vogel, 2006; Tiberghein, 2007). As a country widely seen as the evidence of the variety of capitalism, Japan's recent transformation provides important leverage in understanding the recent change of national institutions under the global economy. In what follows I introduce the existing explanation on Japanese corporate legislative reform.

1.2 Two Explanations

The first and the most popular answer is: Japan needs the reforms. Many observers (Lincoln 2001; Katz 2003; Mulgan 2003) of the Japanese economy have stressed the mismatch between existing structures and the new economic reality. They suggest that Japanese economic institutions were designed for catch-up; as Japan became an economic superpower these institutions, such as strong government regulations, stable business networks, lifetime employment, and so on, became functionless and even obstacles to economic prosperity. When capitalism entered the new phase characterized by rapid innovation and financial globalization, the J-firm model lost its competitiveness and became a source of rigidity. To recover, Japan needs radical reform to unleash market force and forge a more flexible economy. Corporate legislative reform was exactly what Japan needs.

Although this explanation successfully addresses the relationship between economic condition and the Japanese corporate legislation, the desirable outcomes predicted by this explanation did not occur. Fukao et al. (2005) find that domestic M&A has no positive impact on a firm's performance. Firms merged by foreign corporations perform better. However, this is simply because foreign corporations select firms with higher profitability in advance, and has nothing to do with the suggested positive impact. Fukao's (2006) later study also shows that M&A activities even have negative impact on the performance of manufacturing firms. Controlling for intra- and inter-group M&A, the negative result remains. Studies also find that there is no relationship between appointing independent directors and performance among Japanese local banks (Miwa and Ramsayer 2005). Corporations that adopt the newly deregulated committee system perform worse by all major indicators (*Nikkei Bujinesu* August 2006). Furthermore, many internationally competitive corporations, such as Toyota and Canon, were indifferent or even hostile to the corporate regulatory reform (Vogel 2006). Fujimoto (2005) also found that the industries in which Japanese firms show strong competitiveness, including machinery and automobile, fit better with the traditional model of Japanese corporate governance. In short, although it is premature to reach any conclusion about the economic impact of reform, its merits are not as obvious as the literature suggests. Because this explanation is built on the premise of outcome salience, the problematic results of the reform significantly undermine its explanatory power.

The second explanation attributes the reforms to political alliance. Tiberghien (2007) argues that the corporate legislative reform is a "golden bargain" promoted by policy entrepreneurs. The golden bargain refers to national politicians' efforts to attract global investors by radically liberalizing the financial and corporate governance system. Because global investors prefer a high return from their investment, the bargain entails a flexible industrial structure. This may bring social disaster, and the pro-status-quo coalition is therefore more likely to have a stronger voice in domestic politics. Thus proreform political entrepreneurs who are willing to invest their resources in return for future policies they favor play a very important role in reform. In the Japanese case, Tiberghien argues that although the pro-reform coalition did not wield stronger power than the pro-status-quo coalition, political entrepreneurs who pledged to transform the whole system helped to change the political balance that led to the reform. Through the efforts of prime ministers from 1993 to 2006, different reform projects were successfully introduced into the policy arena and made certain progress. However, a strong resistant force also compromised the reform projects; thus the Japanese reform is mainly an enabling one that provides more choices without mandating that all corporations follow the reform plan.

This explanation affords a valuable analysis of the political process of corporate legislative reform. As Tiberghien indicates, many parts of the corporate legislative reform were not popular in the Japanese business community. Political alliance explains how these unpopular reforms overcame the obstacles and passed the legislative process.

However, this explanation begs the question of why the economic bureaucrats supported and even promoted market oriented reform in the first place. In the literature of Japanese political economy, Japanese economic bureaucrats were famous for their hostile attitude toward the market; they held a strategic view of the economy and favored substantial intervention through formal and informal channels to promote strategic industries and maintain economic order (Johnson 1982; Calder 1993; Gao 1997). In other words, the transformation of economic bureaucrats, which is the precondition of Tiberghien's analysis, should not be taken for granted and needs to be explained.

1.3 Bringing the Historical Context Back In

My point of departure lies with two issues. First, this project puts the current reform in the historical context of Japanese corporate law. In this case, an important but often neglected fact is that Japanese political system has already been troubled by corporate scandals since the mid-1960s. Although not until 1990s did the term "corporate governance" formally appear in Japanese public discourse, its elements, including the rules determining what a publicly traded company can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated, had already been a salient political issue in the mid-1970s. In the postwar period, Japanese Diet had amended corporate law in 1949, 1956, 1965, 1974, 1981, 1990 and 1993. Among them, the reform in 1981 was a comprehensive package including the legislation of auditors, board of directors, and general meeting of shareholders. Unlike the recent reform that substantially deregulated the rules of

corporate finance and governance structures, the previous wave of reforms imposed restrictive rules on corporations.

Despite the common name of "corporate legislative reform" (*Kaishahōkaisei* 会社法改正), it is widely agreed that the legislative course after 1997 significantly deviated from that between the mid-1970s and mid 1990s. Inaba Takeo, a retired officer of Ministry of Justice and a law professor at Waseda University, accused the post-1997 reform of deviating from the reform agenda established in the mid-1970s and creating more room for corporate misconduct (Inaba 2006). Kozuka Soichirō, a law professor at Sophia University, appraised the post-'97 reform as truly introducing advanced theories of corporate law (Kozuka 2005). In one of the most popular introductory books to Japanese corporate law, Kanda Hideki (2006), a leading Japanese scholar of commercial law and an important advocate for the reform, also noted the paradigmatic shift of corporate legislation in the last decade. He suggested that the post-1997 corporate legislation deviated from the previous one in the following dimensions. First, the attitudes toward corporate finance were drastically different. Before 1997, corporate finance was highly constrained; deregulations were necessarily accompanied with restrictive requirements of purposes and procedures. After 1997 corporate finance was radically liberalized and financial derivatives were accepted as legitimate corporate assets. Two important cases are stock options and share repurchase. Although convertible bonds and warrant bonds were deregulated before the 1990s, the option was a right granted to specific shareholders and was not admitted as a tradable asset. After 1997, through the

deregulations of a series of financial instruments, the values of options were accepted as a legitimate corporate asset. Share repurchase (also known as treasury stock or share buy-back) was totally prohibited before 1993. After 2001 share repurchase was totally deregulated, with few constraints on the purposes and procedures.

Second, the new corporate law substantially reduced the detailed regulations and provided more options of governance structure (Inaba 2006). Before 1997, corporate legislation tended to add strict rules on governance structure. The new corporate law after 1997 gave corporations more latitude in forming corporate constitutions and internal governance. Corporations were also allowed to issue a variety of special shares that were prohibited or had very high thresholds in old corporate law. The other important change was the deregulation of the board system. The old corporate law required corporations to adopt the two-tier board that differentiated the functions of decision making and monitoring. The new corporate law allowed corporations to adopt the one-tier board that delegates different functions to the committees, if half of their board of directors is independent.

Third, in terms of corporate restructuring, the new corporate law actively reduced the thresholds of market for corporate control (Iwahara 2001). Before 1997 Japanese corporate law required decisions on restructuring to win a supermajority in general meeting of shareholders. In addition, cash was the only financing scheme allowed. Accompanied by the customs of corporate community and cross-shareholding, the market for corporate control was virtually absent in Japan before the mid-1990s. The

new corporate law significantly simplified the procedures, deregulated stock exchange and stock swap, and allowed multiple ways of financing M&A. Furthermore, the new corporate law deregulated triangular mergers that allow foreign corporations to finance M&A through shares of their Japanese subsidiaries (Kanda 2006).

Table 1: Comparison of the Legislative Courses

	1974-1996	1997-2006
Corporate Finance	1. Forbidding share repurchase, stock option; 2. requiring minimal capital	1. Radical deregulation of share repurchase and stock option; 2. abolishing minimal capital
Governance Structure	1. Strengthening the power of auditors and general meeting of shareholders; 2. imposing restrictions on board of directors	1. Deregulating the restrictions on board of directors; 2. introducing independent directors and internal control system
Corporate Restructuring	1. Complicated procedural requirements; 2. only allowing cash in financing the restructuring	Simplifying procedures; deregulating share transfer, share exchange and triangular merger; deregulating international triangular merger

This history of corporate legislation brings both a challenge and an opportunity for researchers of Japanese corporate legislative reform. On the one hand, it refutes the implicit assumption that only after the economic crisis the Japanese government began to adjust its corporate regulatory system. As Pierson (2005) indicates, simply looking at a short time period may limit the analysis to temporarily contiguous factors and leads to tenuous conclusions. If corporate law was also amended before the crisis, a satisfactory explanation must locate the current wave of reform in the historical context and answer

the questions how and why it deviated from the previous track. This posts a great challenge to the literature that largely ignores the historical context.

On the other hand, this history also provides an opportunity for rigorous theory testing. It constitutes what Haydu (1998) calls a "reiterated problem solving" that allows researchers to combine historical narrative and causal arguments. One of the dilemmas faced by historical sociology is the trade-off between historical narrative and general causal laws; when researchers focus on case-specific historical narrative, they are often accused of failing to generate testable general theories (Goldstone, 1992; Kiser and Hechter, 1991); on the other hand, when researchers focus on establishing general law from history, they are often accused of sacrificing context specific knowledge (Abbott, 1992; Aminzade, 1992; Sommers, 1997; Sewell, 1996). Haydu suggests that by linking facts from different periods into larger sequences of problem solving, researchers can balance causal generalization and historical narrative. The explanatory goal of this approach is to account for why, in a given time, actors pursue one solution rather than another. From this approach, the existence of two congruous but distinctive waves of corporate legislation provides an important chance not only to examine the competing arguments on Japanese corporate legislation, but also to advance the theoretical understanding of corporate law in general.

The three dimensions of corporate regulations and two periods of corporate legislation provide variance to test competing theories. A satisfactory explanation must be able to account for the legislation in each dimension and in each period. In the next

chapter, I will examine how well the existing theories explain the Japanese corporate legislation and why the ideational approach should be introduced in this study.

1.4 Bringing the Ideas Back In

Second, this project focuses on the social world in which corporate law was drafted, debated and deliberated. This often overlooked social world includes all participants in the legislative process, including consultants, bureaucrats, and politicians. In the process of the recent reform, the struggle between Ministry of Justice (MOJ) and Ministry of International Trade and Industry (MITI) for the corporate legislation in late 1990s was an open secret. For many advocates of reform, the first identified "resistant force" was the bureaucrats and consultants of Ministry of Justice (e.g. Ueda 2002). On the other hand, when several young entrepreneurs exploited the loopholes created by the new corporate law, commentators suggested that METI bureaucrats are responsible for the market chaos (Uemura 2005). How to account for this struggle between ministries in corporate legislation?

This project suggests that the struggle between ministries reflects the struggle between ideas carried by them. An important insight of sociological institutionalism is that social actors do not act in vacuum; they are restrained and enabled by the beliefs, habits, and taken for granted assumptions shared in their social world (Rowan and Meyer, 1977; DiMaggio and Powell, 1983; Dobbin, 1994; Campbell, 1998; 2002; Fligstein, 2001). This project suggests that this insight can also be applied to corporate legislation. Because a reform project contains multiple pieces of internally coherent legislation, it

cannot be formed overnight and by single politician; it needs continuous efforts by a group of experts sharing the beliefs in the desirability of the reform; the passage in the legislature branch is only the last step of this process.

From this angle, the social world where the bills are formed is by no means an unbiased mediator of structural forces. Although in modern democracies politicians who own the legal power of passing a bill have to respond to economic and political conditions, they have to do so by relying on policy experts (including bureaucrats and scholars) who are capable of forming a meaningful bill. Therefore, although these policy experts don't have the formal legal power to pass a bill, their own beliefs and agenda will influence legislation through their interactions with politicians. Thus dominant beliefs emerging through this interaction cannot be reduced to structural forces outside this social world. The role of ideas carried by policy experts in Japanese politics is an issue as old as the field of Japanese studies; as Gao (1997) demonstrates, dominant ideas shared by scholars and economic bureaucrats had played a crucial role in the formation and transformation of the Japanese developmental state. This project aims to extend this angle by suggesting that similar dynamics can also be found in the recent structural reforms.

1.5 Structure of this Study

This study is structured as follows. In the remainder of this chapter, I introduce the materials I used for this study. In chapter 2 I further clarify the theoretical assumptions behind the literature and introduce the ideational approach adopted in this project. I

define and discuss the key concepts of the ideational approach, including policy paradigm, policy regime and policy field. I also specify the two paradigms in corporate legislation—the jurist paradigm, which treats a corporation as an association composed of stable shareholders and as semi-public institution that has strong impact on social order, and the neoliberal paradigm, which treats a corporation as a nexus of contracts of which the major connection with the society is maximizing wealth. In chapter 3 I analyze the transformation of the independent variable—the policy paradigm and the policy field of Japanese corporate legislation. I show the composition of policy field and the dominant policy paradigms in different period and how the transition occurred. In chapters 4, 5, and 6, I examine the changes of regulations for three dimensions: corporate finance, governance structure, and corporate restructuring. I show that despite business groups' stable policy preference and political influence, the direction of legislation experienced radical shifts in these three dimensions. I argue that only by examining the transformation of the underlying ideational frameworks can one explain the changes in these three dimensions. In the final chapter I summarize the findings, examine counterfactual assumptions and place this study within a broader theoretical inquiry of globalization, nation state, and economic governance.

1.6 Research Material

1.6.1 Legislative Process in Japan

In Japan, there are two ways to form a bill: ministries can draft the bill and submit it through the Cabinet, while Diet members can also submit a bill by themselves to the

Diet. Despite the increase of politician-drafted bills, even until recently the majority of laws were still drafted by bureaucrats (Johnson, 1982; Curtis, 2002). Between 1993 and 2002, 85.5 percent of the newly passed laws were drafted by ministries; only 12.4 percent were drafted by members of House of Representative (HOR) and 2.1 percent by members of House of Chancellors (HOC). The differences in the rates of passage are more astounding: 93.1 percent of the bills drafted by ministries were passed, why only 31.2 percent of the bills drafted by the Diet members were passed (Nakajima, 2004). This is because the Diet members who draft the bills were generally from the opposition parties who only wanted to make a statement for their positions. In other words, bureaucrats play a central role of bill drafting in the legislative process.

Before submitting the bills to the congress, Japanese ministries are required to invite scholars and representatives of social groups to form policy councils (*shingikai,* 審議会). Although there is no clear rule about the legal effects of their conclusions, policy councils often provide an important channel in bringing the opinions of experts and social groups to the legislative process (Vogel, 1997; Esteve-Abe, 2003). The salience of policy councils varies across ministries and issues; for some ministries, policy councils are nothing but a rubber stamp for bureaucratic discretion, while for some ministries, policy councils play substantial roles in providing professional knowledge and coordinating diverse interests. After the ministries submit the bills to the Cabinet, the Cabinet Legislation Bureau reviews the bills and then waits for the cabinet resolution.

Although most bills were drafted by bureaucrats, politicians still had influence through several informal channels. First, bills drafted by bureaucrats have to be reviewed by LDP politicians before being submitted to the Diet. This process is called "incumbent party review" (*yotō shinsa 与党審査*) (Nakajima, 2004). In this process, LDP leaders coordinate different opinions and interests among factions and negotiate with bureaucrats. The final drafts generally already reflect incumbent party's policy preference. Second, a notable or notorious feature of Japanese politics is the particularistic connections between elected politicians and ministries. Diet members support specific ministries bills and budgets in exchange for the needed favor of reelection. The wisely used phrase "*Zoku giin*" (tribal congressmen) is referred to this particularistic practice (Nakajima 2004). Politicians and bureaucrats also often reconcile their disagreement to form policy (Calder, 1988). Finally, the interaction between bureaucrats and political leadership is highly contingent on the political dynamics. In some occasions bureaucrats serve as the think tank for political leaders, while in others political leaders look for consultant from scholars, establish the policy framework and then require bureaucrats to finish the details (Curtis, 2002). Through these informal channels, politicians' opinions can still influence the bills (Nakajima, 2004). After the bills are sent to the House of Representative (HOR), committees are first in charge of review. Committees are entitled to call for hearings and invite experts and representatives of social groups. After the bills are reviewed by the committee, they will

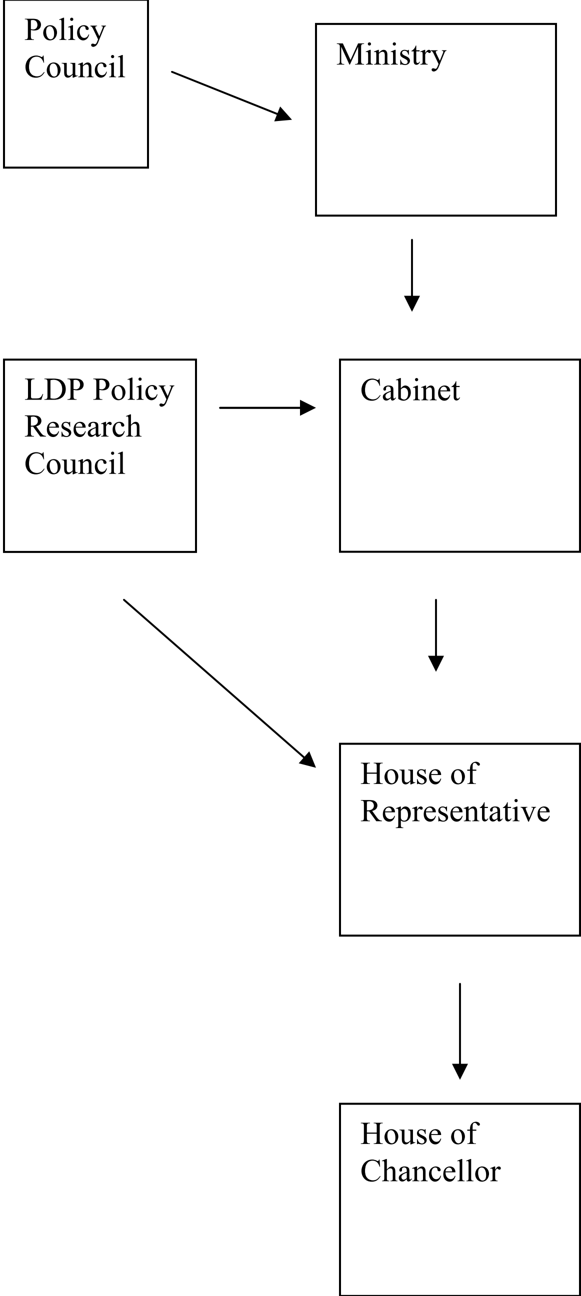
be sent to the general meeting to finish the legislative process. The bills passed by HOR will be sent to House of Chancellor (HOC) to finish the legislation.

This project analyzes the whole process of corporate legislation, including draft and deliberation within ministries. It focuses on how certain issues were raised, debated and framed in the legislative process.

1.6.2 Sources of Data

a. Academic Publications: this project especially focuses on the role of law scholars and economists in the legislative process. In Japan law scholars have long tradition in participating in legislation (Harley, 2001). Therefore, the academic journals and books written by law scholars and economists provide important information on their beliefs and worldview. The most important legal journals for this study are *Jurisuto* [The Jurist] and *Shōjihōmu* [Business Law]. Especially MOJ bureaucrats had tradition of cooperating with these legal journals to review the legislation, call for conference and discuss legislative project. These legal journals and other academic publications provide important information about the underlying legal thoughts of the legislation.

Figure 1: Japanese Legislative Process



b. Economic newspaper: *Nihon Keizei Shinbum, Asahi Shinbum* and *Yomiuri Shinbum*

include detailed information of the legislative process and the opinions of major business groups and scholars on the legislation.

c. Publications by Business Groups: one feature of Japanese politics is the great influence of unified business groups who play a significant role in policy making. The most prominent business group is Federation of Economic Organizations (*Keizai dantai rengokai,* also known as *Keidanren*). These business groups actively publish reports on important policy issues and issue magazines to promote their positions. These publications provide important information about Japanese business community's attitude toward the corporate legislation.

d. Government Archives: four types of government archives are used in this study. The first is the archives of the Diet. During the deliberation, Japanese Diet holds hearing to listen to different opinions, hear the reports from bureaucrats, debate and vote for the bills. The archives of the Diet provide important sources about the major opinions on corporate legislation. The second is the reports published by MITI and MOJ. These two ministries constantly organized study groups and published reports on issues related to corporate legislation. Their reports often served as the guideline of later legislation. Therefore, these reports provide important sources revealing the thoughts shared by bureaucrats. Third, this study also heavily uses the reports and archives published by the special committees. Throughout the 1990s Japanese government organized a variety of special committees to cope with the crisis. The reports and archives of these committees provide important information about the progress of corporate legislation in

the 1990s. Fourth, after 2000 the minutes of Legislative Council are required to be publicized on the internet. They provide important information of the deliberative process after 2000.

e. Strategic Interviews: In this study I interviewed with four key participants of the legislative process. The core task of this step is to confirm the finding found in documents. They include

1. Inaba Takeo: retired MOJ officer who took charge of the corporate legislation in the 1980s

2. Nakahara Toshihiko: MITI bureaucrats who take chare of the corporate legislation after 2000

3. Egashira Kenjirō: Law professor of Tokyo University and the leading member in the Legislative Council

4. Iwama Yoshihito: Director of the Legal Affair of Keidanren

Ch.2 Efficiency, Power and Ideas

The most prominent approaches in social sciences are interest based models that treat the pursuit of self-interest as the major force driving social actions. There are two major branches of interest-based models in the scholarship of corporate legislation. The first branch, which is derived from the law and economics tradition, treats institutions as the instruments to enhance aggregate interests of the whole system. In other words, institutions serve the function of maximizing aggregate interests. In this study I call this the efficiency approach. The second branch, which is derived from the pluralist tradition of political science, suggests that the struggle and negotiation among self-interested actors form the institutions. In other words, the institution is an arena for the pursuit of self-interest. In this study I call this the power approach. These two approaches dominate the empirical studies of corporate legislation. In this chapter I first discuss these two models and their problems. I then introduce the institutional approach to corporate legislation.

2.1 The Efficiency Approach to Corporate Law

2.1.1 Theoretical Foundation

The efficiency approach to corporate law is derived from the agency theory, which is one of the core theories in the tradition of law and economics. It argues that the purpose of courts, laws, and other legal arrangements is to increase social wealth. Its reasoning is the so-called Kaldor-Hicks efficiency, which refers to the condition that the increase in social wealth minus potential damage to a third party is positive (Posner

1990). Therefore institutions with better efficiency will and should replace those that are less efficient. In the field of corporate legislation, the core issue is the agency cost of owners. Berle and Meanss theme of managerial dominance presents a puzzle: if large corporations are dominated by managers, and small shareholders are exploited as Berle and Means suggest, there should be no investors willing to risk their money. However, the active stock market shows that rational investors continue to invest despite the managerial dominance that supposedly harms their interests. Why do rational actors keep investing?

Agency theory solves this question by providing a new angle for analyzing the modern corporation. It suggests that a corporation is a nexus of contracts between shareholders and managers. On the one hand, firms need to raise sufficient money and the managers who run these firms lack the capital. On the other hand, many investors want to earn returns but lack either the expertise or the interest to run the firm. Thus a corporation is a contractual solution of this problem. Jensen and Meckling, the founders of agency theory, define the private corporation or firm as "one form of legal fiction which serves as a nexus of contracting relationships and which is also characterized by the existence of divisible residual claims on assets and cash flows of organization which can generally be sold without permission of the other contracting individuals" (1976:311). In other words, the critical issue for the modern corporation is not who controls, but how to establish the contracts between shareholders and managers. Because shareholders delegate the authority of decision making to managers, self-

interested managers may not necessarily act in the best interest of shareholders. Managers have incentive to expropriate the corporate assets, while it is difficult for shareholders to control managers' behavior. Agency theorists suggest that the solution is providing incentives for managers to act in the shareholders interest. The best way to solve agency problems is market mechanism, not mandatory governmental regulation. Even shareholders cannot control the corporation, but under the right incentive scheme managers will still be willing to act in their interests through market transactions. The most effective scheme is to bind managers' compensation with stock prices that reflect managers' performance. In other words, investors who do not control the corporation can still avoid managerial expropriation through an appropriate incentive scheme and efficient financial markets.

In agency theory, the key mechanism monitoring managers is efficient financial markets. Actors in financial markets value capital assets (such as shares of stock) according to all available public information and determine the prices. Because financial markets value expected income rather than current or past performance, they are the best predictors of the consequences of present-day actions. Financial market reactions thus provide important instructions for corporate strategies and structures. They also provide investors a guideline for investment. In efficient financial markets, investors have no need to substantially control the corporations or obtain knowledge of specific industries; they can rely on the signals "summarized" by the financial markets to make wise investments. Their future orientation and informational efficiency imply that

financial markets can solve the agency's problems by binding managers' interests with investors (Jensen 1988; 2001; Gordon 1997). In short, from this approach financial markets not only provide better potential matches between investors and those needing capital, but also help the distribution of information.

2.1.2 Arguments

Although the original version of agency theory is not one of corporate legislation, it inspires a functionalist approach to corporate law. Easterbrook and Fischel (1991) present a representative version of efficiency approach to corporate law. Their argument is summarized as follows. First, self-interested entrepreneurs, managers, and investors are driven by the pursuit of maximum profits. Therefore, they have the incentive to find the best way to be associated in a venture. The founders of a firm have incentive to create the optimal governance structure for attracting investors. Second, no universally best relation among managers, investors, and other corporate constituencies exists. The changing environment constantly creates new challenges to corporations, and the right solutions vary across firms and change over time. Third, a corporation's choice of governance structure does not create substantial third-party effects. Thus investors have the freedom to terminate the contract by withdrawing their investment. Fourth, maximizing investors' interests automatically benefits others and can also lead to the best interests of the entire society. Therefore regulation over the corporation should facilitate investors' efforts to maximize their wealth. The above assumptions suggest that corporate law should be seen as a framework that serves the functions of constructing

value-maximizing corporate structures, providing contractual solutions for managers and shareholders, and maximizing private wealth by reducing agency cost. Corporate law should not intervene with substantial arrangements of governance structure; its tasks should be limited to preventing opportunism and reducing the cost of contracting. Corporate law supplements but does not replace the contracts formed by parties.

Three issues receive special attention from this approach: the protection of minority shareholders, managerial flexibility, and market of corporate control. First, how well minority shareholders are protected against the expropriation by managers and controlling shareholders is a critical factor influencing the financial market and economic prosperity. Many law scholars extend this argument and suggest that good legal protection of minority shareholders can reduce investors' risk, and thus enhances the incentive for investment. As a result, countries with better protection of minority shareholders often have an more efficient economy. Global competition forces countries to better protect minority shareholders (Kraakman 1998).

The second issue is the balance between mandatory and enabling rules. Mandatory rules force private agents to follow strict rules prescribed in the statutory law, while enabling rules provide optional statutory provisions and allow parties to reallocate their rights based on consent (Coffee, 1989). A classic example of enabling rules is the phrase in the Delaware code "unless otherwise provided in the certificate of incorporation." Under the Delaware code, incorporation is not that different from contract making; parties can choose from many possible forms of corporate contracts based on mutual

agreements. In other words, enabling corporate law does serve the role of facilitating contracts, and parties are allowed to establish their own contracts once they reach agreement. However, it does not imply that all mandatory rules are inadequate; mandatory rules play the function of promoting long-term, complex contracting by restricting opportunism. Mandatory rules pave the way for court oversight that is essential in the contractual relationship. Thus mandatory rules should still exist, but have to be limited to the role of facilitating contract formation; corporate law should mainly be composed of enabling rules that allow shareholders and managers to negotiate with each other to form optimal contracts. Corporate law that allows more latitude of financial operations, stock issuance, corporate constitutions, and governance structures for corporations can encourage optimal governance arrangement and enhance efficiency. In contrast, too many mandatory rules hurt efficiency by restricting parties' choices and limiting potential bargaining (Easterbrook and Fischel 1989, 1991).

Third, corporate law influences the establishment of the market for corporate control that benefits shareholders and society by reducing agency cost. Market for corporate control is especially important for agency theory; it plays the following functions. First, it reduces agency cost by allowing better managers to control corporate assets. The managers in a given corporation often have inertia and have difficulty reforming them. Market for corporate control can bring new management teams who can reform the corporation and benefit all (Easterbrook and Fischel 1991). Second, even for corporations that are not taken over, market for corporate control can discipline

managers. Stock price contains information on the quality of management; a low stock price implies higher risk of takeover. To avoid takeover, managers have incentive to raise the stock price by enhancing the corporation's profitability and dividends and improving management (Jensen 2000). In other words, a hostile takeover not only benefits the target of the takeover but the whole economy (Rappart 1990). Third, market of corporate control can encourage the optimal corporate governance diversity within national systems and within individual firms. Because organizations with heterogeneous members perform better, corporate governance diversity can enhance economic performance. Market for corporate control is an important way by which a corporation improves its internal diversity; increasing merger activities can stimulate managerial innovations that improve the whole economic system (Milhaupt and West 2003).

The main mechanism shaping corporate legislation from the efficiency approach is competition between jurisdictions. Because shareholders and managers will choose jurisdictions with the best corporate law to incorporate, countries will fall behind in competition if they fail to adopt the best practices. Firms organized and operated according to this model enjoy advantages in global competition; they can access more capital with lower cost and rapidly enter new markets, develop innovative managerial practices, and reorganize old business in a flexible fashion (Jensen 1989). Managers will choose a jurisdiction that they believe offers the best opportunity for success. If managers and shareholders perceive that a state's corporate law cannot maximize their

interests, they can simply move elsewhere. Therefore jurisdictions compete in attracting investments and incorporation. As other countries continue to lose in global competition, they have no choice but to adopt the U.S. model. This process will eventually force all jurisdictions to establish the same legal environment to attract or retain corporations (Romano 1993). Because protection for the minority shareholder, enabling rules, and markets for corporate control can create an efficient economy, countries without these rules will lose in global competition and will be forced to adopt these rules. Two prominent law scholars, Hansman and Kraakman (2000), declared the end of corporate law and suggested the inevitable convergence of corporate law on the standard shareholder model characterized by strong investor protection, high managerial flexibility, and an active market for corporate control. They suggest that all alternative models, including the manager-oriented model, the labor-oriented model, the state-oriented model, and the stakeholder model, have proved to be inferior to the standard shareholder model.

2.1.3 Critique

The efficiency approach provides a parsimonious argument that can not only empirically explain but also normatively instruct corporate legislation. It has become the dominant analytical scheme for corporate law and the corporate governance problem among economists and U.S. scholars of commercial law. However, it has several theoretical drawbacks. First, even if we agree that efficiency is the driving force for corporate legislation, the efficiency approach that prioritizes agency cost underestimates

the trade-off among different types of costs. Transaction cost is widely perceived as another important factor that shapes efficiency. Organizational economists and economic sociologists have demonstrated that hierarchal organization and organizational networks are important ways to overcome the problems of transactional cost, opportunism, and uncertainty (Williamson 1985, 2003; Podolny 1998). The efficiency approach rarely pays attention to these dimensions and fails to consider the potential trade-off between agency cost and other types of cost. As Kestor (1996) indicates, minimizing agency cost often occurs at the expense of rising transaction cost, and on many occasions hurts efficiency. Simply minimizing agency cost does not necessarily bring optimal efficiency.

Second, the efficiency approach overlooks other legislative goals, such as accountability and economic stability. Especially when actors consider long term impact of institutional change, they may prioritize other goals. Different legislative goals are by no means harmonious, and thus trade-off is inevitable. For example, the rules to enhance accountability may place stronger constraints on managers and thus curtail managerial flexibility. The recent controversies around the Sabina-Oxley Act show the results of this contradiction (*The Economist* 2005). The efficiency approach provides no clear explanation of how lawmakers can reach the suggested optimal trade-off among different legislative goals.

Third, even if an optimal legal model exists that can bring the best trade-off among different types of costs and legislative goals, how lawmakers are willing to and able to

achieve it is still questionable. The efficiency approach does provide a plausible model of "race to the bottom" to explain how jurisdictions converge on the best model. However, the applicability of this model is highly limited. "Race to the bottom" can only occur in the United States where corporate law is legislated by the states while corporations are free to move within the nation. Outside the United States, lawmakers hardly face this kind of direct threat. The cost of relocating corporate headquarters in other countries with centralized legal systems is much higher. In other words, if lawmakers actually face less direct threat than the efficiency approach suggests, how lawmakers can know these "best" practice becomes a serious question.

In addition to the theoretical drawbacks, the empirical evidence of the efficiency approach is fuzzy. Because the efficiency approach is built on the assumption of outcome salience, to what degree the empirical evidence supports the supposed optimal corporate regulatory regime is crucial for its validity. Unfortunately the empirical evidence does not favor the efficiency approach. First, the relationship between legal protection for minority shareholders and financial development is tenuous. Rajan and Zingales (2003) find that the positive correlation between market capitalization and investor protection appeared only after 1980, not before. For example, in 1913 market capitalization (the size of the stock market as a fraction of G.D.P.) of France was higher than that of the United States, even though the legal structure of each country has not changed much. Furthermore, the overall market capitalization in the world reached its peak in 1913 and then declined for half a century. Not until the late 1970s and early

1980s did it rise again. In other words, the causal relationship between legal protection and financial development shown by LLSV is highly conditional.

There is also little empirical evidence that supports the positive results of market for corporate control. The argument that market for corporate control can help discipline managers finds no evidence. Frank and Mayer (1996) examined the hostile takeovers in Britain in the mid-1980s and found that hostile takeovers did bring a higher chance of board turnover and restructuring. However, the chance of being taken over has nothing to do with prior performance. Fligstein's (2001) analysis on the financial concept for corporate control obtains similar results. In short, hostile takeovers do punish managers; however, this punishment has nothing to do with performance. In other words, they provide no incentive for managers to improve their performance. In addition, the argument that market for corporate control can enhance corporate performance also does not stand. Moeller et al. (2005) examine the value of acquiring firms in M&A activities and find a striking result. They report that acquiring-firm shareholders lost an aggregate 4 billion dollars between 1980 and 1990 and 216 billion dollars between 1991 and 2001. Even if one subtracts the unusual loss between 1997 and 2001 when the greatest loss occurred, the average return of M&A is still negative.

In short, the efficiency approach does provide a plausible theory that attributes corporate legislation to the pursuit an efficient economic system. However, it does not afford a convincing account of why and how lawmakers follow the best practice

prescribed by it. Its assertion of the superiority of the proposed model also lacks empirical evidence.

2.2 The Power Approach to Corporate Legislation

2.2.1 Theoretical Foundation

The second interest-based model, power approach, also assumes the predominance of incentives and interests. However, interests function in a totally different way in this approach. It departs from the efficiency approach in two issues. First, it assumes that self-interested actors have diverse and even conflicting preferences of corporate governance outcome according to their different positions in the corporation and in the whole economic system. Second, actors with similar positions from different firms will organize together and try to make the laws favorable for them. Different organized actors will thus bargain and struggle with one another outside the firm. Corporate legislation therefore reflects the power balance among different groups. Gourevitch and Shinn's statement can sufficiently demonstrate this position: "Corporate governances reflect law and regulation. Law express the outcome of political process—a broad political bargain among the major players contesting a variety of policies that influence incentives, which in turn produce corporate governance outcome" (2005:8).

In short, in this approach corporate legislation is seen as an arena where organized actors struggle for their self-interest. Unlike the efficiency approach that predicts the ultimate convergence on the best model, the power approach suggests that diversity is brought by different political structures and power balances in different countries.

Although the power approach defines their dependent variable by a broader notion of corporate governance because they identify corporate law as one major arena in which social groups struggle with each other (Gourevitch and Shinn 2005; Roe, 2006), in this project I treat it as a theory of corporate legislation. Thus the core issue for the power approach is: what are the major political cleavages that sorts groups into opposing political camps and frames the political struggle?

Arguments

Two types of political cleavages that structure the political struggle are addressed in the literature: class and sector. The class model suggests that the struggle and bargaining among organized owners, managers, and workers shape the corporate law. These three groups have different preferences for corporate governance outcomes. Shareholders want to maximize their returns, minimize costs, and make sure that managers work for their interests. Managers seek income, job security, and managerial autonomy. Laborers want higher wages and job security, and to try and restrain shareholders power. Each group can bargain with another in the political process; much of the difference in corporate legislation can be attributed to the different results of bargaining. The coalitions and conflicts among owners, managers, and workers is the main determinant that influences policies for political institutions. Gourevitch and Shinn (2005) illustrate the potential outcomes of different political coalitions and conflicts. If owners and managers successfully form a coalition and defeat labor the blockholders may lobby for minority shareholder protection for higher premiums paid by the investor, which will

lead to diffused ownership. This model is best represented by the U.S. model. After the Asian financial crisis, Korea also shifted to this model. On the other hand, when labor wins the battle, it prefers to reduce minority shareholder protection for the sake of job security. This leads to a blockholder regime. The best example is Sweden.

On the other hand, if managers and labor successfully form a coalition, they may promote corporatist negotiation that leads to the blockholder model. The best examples are Germany and Japan. However, if owners ally with authoritarian states and defeat the coalition between managers and labor, oligarchy may occur. This also leads to the stockholder model. China and Singapore belong to this category. The third situation, transparent conflicts, is characterized by the struggle between the managers and the coalition of owners and laborers built through the operation of the pension fund. When pension funds become prominent investors in some economies, transparent management becomes the common interests shared by owners and workers. The victory of the coalition of owners and laborers may lead to stronger minority shareholder protection. An interesting case is Chile, where left-center government facilitated the legislation of shareholder protection. However, when the managers win the battles, managerialism emerges and leads to the stockholder model.

The second type of political cleavage is sector. Gourevitch and Shinn (2005) suggest that sectoral conflicts occur when managers, labor, and owners in certain industries join together in a broad bargain. Labor cedes control in exchange for job security and higher income; blockholders and managers gain labor's support to resist hostile takeovers. Thus

the rivalry in bargaining becomes the coalition in other industries or other groups of firms. This model often results in the blockholder model of corporate governance. In addition to the ownership structures, sectoral cleavage implies another type of conflict: insiders versus outsiders. Rajan and Zingales (2003) have examined the openness of trade and financial development in 1913 and the late 1990s and find strong correlations between them. The authors then pooled the data between 1913 and the 1980s when cross-border capital declined. They found that the correlations become weaker and even disappear when cross-border capital flow is weak. After the end of the Great Depression, the rise in demand of public insurance hindered the recovery of the financial market. The comparison between Japan and the United States further shows that the centralized vested interests in Japan successfully blocked financial development, while the fragmented interests in the United States failed to do so. This difference accounts for the development paths of financial development in these two countries.

Critique

Compared with the efficiency approach, the power approach provides a clearer theory of social actors. Its underlying assumption is that lawmakers have incentive to represent the interests of their constituency. It is clear that corporate law influences the interests of employees, managers, and shareholders, and that these stakeholders have the incentive to influence the legislation. However, the power approach leaves several problems. First, it assumes that employees, shareholders, and managers will choose to pursue their interest by collective bargaining in the political process. This assumption is

at best problematic. Collective action is not costless; as Olson and other theorists of collective action indicate, the free rider problem may prevent rational actors from cooperating with one another even if successful collective action will bring a desirable outcome (Olson 1964). Actors have at least three choices to pursue their interests: political mobilization to change the law, collective negotiation among social groups, and individual negotiation within each corporation. Corporations may form informal agreements through cartels and associations; managers and employees may negotiate within their own firms. Thus the critical question unanswered by power approach is: why actors choose to, or are allowed to enter the political process in the first place. If actors do not enter the political process, the power approach loses its explanatory power. Unfortunately, much of the empirical evidence provided by power theorists simply shows the correlations between ownership patterns and political structures. It is still unclear to what degree these correlations are influenced by ownership patterns through the political process.

Second, despite the theoretical assertion, the political struggles between organized managers and organized shareholders in the legislative process are rarely found. Little evidence shows that corporate governance is the target of class or sectoral negotiation. Most class struggles concentrate on the issues of wages, job security, and working rules, and rarely extend to the issues of corporate legislation. The sectoral conflicts concentrate on issues of free trade and protectionism. If the agent collectively representing managers is lacking, and if issues of corporate governance are not the targets of class or sectoral

negotiation, it is highly possible that the observed correlation between the strength of the labor class and ownership structures is the result of informal agreements rather than conscious struggle in the political process.

2.3 The Ideational Approach

2.3.1 Theoretical Foundation

The departure of the ideational approach from the interest-based models lies in the fundamental assumption about social behaviors. Both interest-based approaches presume that individuals' choices and preferences are self-evidenced and play the central role in shaping institutions. The efficiency approach assumes that institutional development reflects the preference of the whole system, while the power approach assumes that institutional development reflects the balance of individual interests. From the sociological approach, social behaviors are not shaped by a priori interest but by the "scripts" prescribed by the ideas, norms, knowledge, and worldviews shared by social actors (Dobbin 2004). Individual choices and preferences, factors serving as the explanatory variables of interest-based models, cannot be properly understood outside of the cultural and historical framework in which they are embedded (DiMaggio and Powell 1991). This does not imply that calculation plays no role in social actions. Rather, it suggests that calculations cannot occur in a vacuum and must be based on these scripts. Interest-based models are more adequate in explaining specific events within specific contexts; however, these contexts that shape long-term institutional developments cannot be explained by them (Dobbin 2004). This does not mean that

these scripts will not change; the ideas, norms, knowledge, and world cannot be immune from the ongoing disputes. The results of these disputes significantly influence the persistence of and changes in these scripts.

In short, the ideational approach suggests that the analysis of social behaviors should focus on what these scripts are, where they come from, and why they change. It does not imply that social actions are predetermined by these scripts; however, actors need these scripts to make sense of the reality and determine the adequate responses.

2.3.2 Ideational Approach in the Studies of Public Policy

In the field of public policy, two issues are critical in shaping the direction of institutional development. The first is the meaning systems that shape the understandings of appropriate policy purposes. One of the core insights of organizational institutionalism is that actors are often motivated more by what they believe to be appropriate than what they believe too be beneficial for them (Powell and DiMaggio, 1991). Policymakers must consider the justifiability of the proposed policy or law. No matter how policymakers look out for their own or their constituencies' interests, they have to justify their actions in the name of public interest. The interest-based models cannot explain why some ways of pursuing self-interest, such as buying and selling political influence, are widely seen as corruptive and are often prohibited, even when they do not violate anyone's short-term interest. The dominant meaning system that shapes what public interests are is crucial in justifying a policy. These

meaning systems must be collectively established and thus are beyond policymakers' ability of calculation.

The second is the belief in the ends and means relationships of policies. Even if the policy purpose is certain, how to achieve it is still an important question. Because the feedback process of policymaking is generally ambiguous, indirect, and slow (Pierson 2004), policymakers have difficulty immediately realizing the outcome of their actions. Especially for issues with technical complexity, predicting policy outcome is extremely difficult. However, policymakers suffer from serious backlash if their actions bring undesirable outcomes. Policymaking is possible only when policymakers are convinced of the desirable outcomes, no matter by what standard and no matter if it is true. As Swindler (1986) suggests, culture provides not only values but also a "tool kit" of habits, skills, and styles that help actors cope with different kinds of problems. In other words, even instrumental actions are inevitably involved with ideas carried by actors. Actors must rely on certain scripts that are believed to deliver desirable outcomes. These scripts are derived from either academic knowledge or successful experience.

The ideational approach portrays a very different dynamic of policymaking from the interest-based models. In the ideational approach, policymaking is conducted in social fields where the process of institutionalization occurs. In organizational sociology, "field" refers to the aggregates of organizations constituting a recognized area of institutional life (DiMaggio and Powell 1991; Fligstein, 2000). Ideas influence policies by providing underlying cognitive frameworks taken for granted by actors. This approach

is derived from phenomenological sociology, which highlights the contextual and interpretive natures of social actions (Berger and Luckmann 1966). Social actors are located in and constitute a social world in which they recognize one another, form shared understandings, and develop formal or informal institutionalized arrangements (DiMaggio and Powell 1991). This can also be applied to policymaking. In this project I use the term "policy field" to refer to the totality of the social world that locates and is composed of relevant actors in policymaking. Once a field is formed, participants in the field will form common understandings about the meaning of a certain policy and the adequate means for achieving it.

The critical participants in the policy field are the providers of ideas including scholars, professionals, and bureaucrats. Although they do not own the legal authority of legislation, they influence and even shape institutional development in two ways. First, they help to define the purpose of legislation. As Weber (1978) and Dobbin (1994) have suggested, rationality is one important source of legitimacy in modern society. Thus the acceptable policy purpose is generally prescribed by the prevalent rational meaning systems. It is easier for those who have professional knowledge to determine whether an issue should be perceived as a problem or a normal phenomenon in the given rational meaning system. Furthermore, because science and rationality themselves are sources of legitimacy in modern society, experts participation is an important source of legitimacy. In this process their beliefs will have profound impact on the definition of appropriate policy purposes.

Second, they provide the professional knowledge to reduce the uncertainty of policymaking. Politicians generally lack the professional knowledge for predicting policy outcomes; they need to rely on experts to provide the knowledge. This professional knowledge may not necessarily be limited to scientific knowledge: the knowledge about the details in administration and legal procedure may also be valuable in policymaking. Thus bureaucrats often have great influence on policymaking due to their knowledge of the administrative details. The most prominent example is economic policy, which can significantly influence material interest. Literature shows that economic experts played a critical role in the transformation of Eastern Europe (Bockman and Eyal 2002); Japan's developmentalism (Johnson 1982; Gao 1997; Heins 2004); the diffusion of Keynesism (Hall 1989); and the rise of neoliberalism in the United States (Campell 1998) and Latin America (Babb 2004).

2.3.3 Policy Paradigms in Corporate Legislation

Following Hall's terminology, in this paper I use the term "policy paradigm" to indicate an interpretive framework that instructs "not only the goals of policy and the instrument that can be used to attain them, but also the very nature of the problems they are meant to address" (1993:). When a policy paradigm is institutionalized in a policy field, I call this combination a policy regime. A policy paradigm tends to be self reinforcing through the following processes (Campbell 1998). First, policy paradigm limits the choices of policy. Because actors in a field believe that the interpretations and solutions prescribed by the dominant policy paradigm are the only possible choice, they

will exclude proposals that are not consistent with the dominant paradigm. The lack of alternative policy proposals will further strengthen the policy course prescribed by the dominant policy paradigm.

Second, policy paradigm also enables actors to generate solutions to their problems in an easier fashion. Because actors in the field already share certain assumptions and a worldview, it is much easier to mobilize them to reach a common goal. Policy regimes also allow actors to figure out the situation and provide solutions in a timely manner. The policy paradigm can provide quick answers to the problems faced by policymakers. Furthermore, the accumulation of policies creates the sunk cost and thus facilitates the persistence of the policy course. Changing the existing policy course entails a series of legislations or policies that cost much more than a sporadic breakthrough. Therefore, an institutionalized policy paradigm tends to be self-reinforcing and resistant to change.

In the field of corporate legislation, policy paradigms shape the regulations for corporations through two paths. First, policy paradigms define the relationship between corporations and the whole society. A corporation can be either defined as a quasi-public institution embedded in a broader society, or as a pure economic organization whose purpose is to maximize economic return. Second, policy paradigms define the relationship between a corporation and its shareholders. A corporation can be defined either as a real entity composed of stable shareholders or as a nexus of contracts that is repeatedly renegotiated.

The first divergence in corporate legislation is whether a corporation is seen as a quasi-public institution that has profound impact on the social order, or as a purely private organization whose major relationship with the society is producing wealth. This difference will significantly influence the perceived corporate governance problem and the appropriate purpose of policymaking. Tsuk (2006) indicates that the perceptions of the corporate governance problem have experienced a drastic change since the 1930s, when Berle and Means first published their pioneer work. When they questioned managerial control of large American corporations, their concern was with the concentration of economic power that hurts democratic society. However, later theorists of corporate law shifted the focus to the loss of efficiency and shareholders interests. Tsuk's analysis provides important clues to this study. Although corporate law belongs to the category of private law, the different assumptions about the relationship between corporations and broader societies have profound impact on the legitimate principles of corporate legislation. When a corporation is seen as a quasi-public institution, accountability and social order become important concerns for corporate legislation. Lawmakers are more likely to sacrifice flexibility for maintaining social and economic order. On the other hand, when the corporate governance problem is perceived as one of pure economic efficiency, flexibility and liquidity will surpass the concern for accountability and stability. It is also more likely to be linked with economic prosperity.

The second issue is whether a corporation is seen as a "real" entity composed of stable shareholders, or merely an abbreviated way to write shareholders name together

for transactions (Ochiai 1996). As Iwai (1999) indicates, this divergence is rooted in the historical debates about the meaning of the legal personality of modern corporations. Since the 1920s there have been debates about the nature of a corporation. This difference has profound impact on the conceived solutions to corporate governance problem. When a corporation is seen as a real entity composed of stable shareholders, the legal relationship between shareholders and the corporations are similar to that of citizens and the nation. Thus corporate governance is seen as the exercise of shareholders "sovereignty"; the conceived solution to the corporate governance problem lies in the allocation of rights among the different corporate organs, including the general meeting of shareholders, the board of directors, and the board of auditors. Thus shareholders are protected by internal democracy within a corporation. On the other hand, when a corporation is seen as a nexus of contracts, shareholders are not that different from parties involved in repeated transactions; therefore it make little sense to ensure the "sovereignty" of shareholders. The focus of governance lies in ensuring fair terms of transactions and liquidity.

Differences in the policy paradigm have profound impact on the responses to the same issues. Because it is rooted in the tradition of civil law, I use the term "jurist paradigm" for the paradigm that treats a corporation as a quasi-public entity composed of stable shareholders. I call the combination of jurist paradigm and the field where it is institutionalized a jurist regime of corporate legislation. Because it favors market mechanism as the solution to the corporate governance problem, I call the paradigm that

treats a corporation as a pure economic nexus of contracts a neoliberal paradigm. I also call the combination of the neoliberal regime and the policy field a neoliberal regime of corporate legislation.

The first issue that reflects the difference in policy paradigm is the regulation for corporate finance. Although paradigms accept equity finance, they have different attitudes toward it. For the jurist paradigm, equity finance implies a higher risk of price manipulation that hurts the accountability of corporations; thus the jurist regime tends to restrict equity finance. Because equity finance implies a stronger price mechanism, it is the central issue for the neoliberal regime. Strengthening corporate finance is the key measure for enhancing shareholders interests and maximizing wealth. It thus tends to encourage equity finance.

The second issue is the regulation for governance structure. Because the allocation of power among corporate organs influences the checks and balances within a corporation, it is the central issue for the jurist paradigm. It tends to grant stronger power to organs that can check the executive branch. It also tends to impose more rules on the executive branch. In the neoliberal regime, the best mechanism for prohibiting the executive branch from self-dealing is market mechanism. Restraining the executive branch by imposing more regulations on power of the board of directors would hurt the efficiency of the corporation. Thus the neoliberal regime tends to deregulate regulations over the board of directors.

The third issue is corporate restructuring, which includes divesture, merger, and acquisition. Because restructuring implies fundamental change of the corporate entity, the jurist regime views it with a conservative attitude. To protect creditors and shareholders, the jurist regime tends to impose strict rules about the procedures, financing scheme, and purposes of restructuring. On the other hand, under the neoliberal regime, corporate restructuring is part of the market mechanism that can improve corporate governance. The neoliberal regime thus encourages corporate restructuring.

Table 2: Comparison of Approaches

	Efficiency Approach	Power Approach	Ideational Approach
Theoretical Foundation	Law and Economics	Political Pluralism	Sociological Institutionalism
Argument	Corporate law should is a framework that serves the functions of constructing value-maximizing corporate structures, providing contractual solutions for managers and shareholders, and maximizing private wealth by reducing agency cost.	Corporate legislation is an arena where organized actors struggle for their self-interest. Corporate law is shaped by the power balance among shareholders, employees and managers.	Corporate legislation is shaped by the dominant policy paradigm that defines the nature of a corporation and its normal relationship with the society
Main Actors	No clear actor	Interest Groups	Policy Experts
Mechanism for Change	Competition among Jurisdictions	Changes of Power Balance	Paradigm Shift

2.3.4 Power and Efficiency in the Ideational Approach

The ideational approach does not deny the role of power and efficiency but insists that their impact is contingent on the legislative regime. First, as I mentioned earlier, the critical problem faced by the efficiency approaches how the actors believe and are willing to adopt the suggested optimal solution of the corporate governance problem. From the institutional approach, what really matters is not the actual relationship between corporate legislation and economic performance but the perceived one. In other words, the relevance of the efficiency approach does not lie in empirical validity, but whether it serves as the normative schema that guides corporate legislation. The efficiency approach itself serves as a policy paradigm. When the legislative schema prescribed by the efficiency approach is institutionalized in the policy field, lawmakers will adopt market-oriented reform. However, when the legislative schema prescribed by the efficiency approach is not institutionalized, lawmakers may not see economic efficiency as the purpose and market-oriented reforms as the solution of corporate legislation.

Second, the power approach is right that corporate legislation influences the interests of social groups and thus provides the incentive for political mobilization. Managers want to expand their discretional power and control of corporate resources; shareholders want to control managers and increase economic returns; and employees want job security. However, the critical question is whether these preferences can be translated into the legislative process. The ideational approach suggests that not all preferences can equally enter the legislative process. A policy paradigm constrains some

preferences and enables others. When their preferred policy is not perceived as legitimate in the dominant paradigm, interest groups have difficulty making bargains in the political system. In short, institutional analysis does not deny the impact of interests but suggests that it is contingent on the dominant ideational framework.

2.3.5 Source of Change

If policy paradigms have a profound impact on corporate regulations, a critical issue in institutional approach is when and why changes occur. Because the institutional approach is designed to explain the persistence of behaviors, it has difficulty explaining the changes of institutionalized patterns. However, few institutional practices are immune from change; in the studies of public policy researchers witness the changes of policy courses in a variety of fields (Babb 2002; Parsade 2006; Fourcade and Babb 2004). How to incorporate changes is important for the ideational approach. In this study I suggest that the policy field can be treated as the focal point for analyzing the persistence and shift of policy paradigms. As I suggested earlier, once a policy paradigm is institutionalized in a policy field, it tends to be self-reinforcing. The sources of change are more likely to come from forces outside the field. However, to change the dominant paradigm these forces must pass through the policy field. In other words, the changes in the policy field occur prior to the paradigm shift; only when new players bring new ideas into the social world of policymaking can the policy course shift. The question is: what drives changes in the policy field?

The first force that drives change is crisis. Kuhn's (1970) analysis of the shift of scientific paradigms provides important insights into the shift of the policy paradigm. In his analysis on scientific revolutions, Kuhn (1970) argues that a single anomaly or failure of prediction will not constitute a challenge to the dominant paradigm; researchers will try to solve the anomaly under the old paradigm. However, as the anomalies accumulate, the old paradigm faces crisis. Older generations of scientists tend to stick with the traditional paradigm, but younger generations will try to find new ways to solve the problem. In the field of policymaking, crisis can either be the continuous failure to produce a desirable policy outcome or an overwhelming crisis of the whole nation.

In the field of public policy, crisis comes from multiple sources. For scientific paradigms, crisis is limited to the accumulated failure of explanation; for policy paradigm, crisis not only comes from the failure of delivering desirable policy outcomes, but also the changes of political atmosphere. Unlike scientific community that only needs to respond to scientific discoveries, policy community has to respond to economic and political changes. Although crisis is much more ambiguous in policymaking than in scientific research, the sense of crisis does trigger distrust toward the existing paradigm and the motivation to create a new one. Without crisis policymakers are more likely to stay in the status quo.

Although crisis is an important factor triggering change, it does not guarantee change. The second condition of change is the availability of an alternative paradigm.

One factor contributing to the persistence of the policy paradigm is the sense that available alternatives to the dominant one are lacking. A new paradigm can help to reduce uncertainty, make collective action and coalition building possible, attack existing institutions, act as a blueprint for new institutions, and make institutional stability possible after new institutions are built (Blyth 2002). Although multiple sets of ideas always exist in modern society, these ideas may not necessarily be able to become a policy paradigm that can provide new ways to define appropriate policy purpose and new methods to cope with problems.

The third element of change is new actors in the policy field. The new paradigm is more likely to be brought by outsiders or marginal actors in the field. Changing the existing policy paradigm requires reflexive actors who are aware of alternative way of thinking. As Kuhn (1970) suggests, once a new paradigm emerges younger scientists are more likely than the older generation to embrace it. As the new paradigm shows better explanatory power for anomalies, the paradigm shift will occur and the new paradigm will finally replace the old one. In the field of public policy, this element is different from the scientific activities. Because no paradigm can satisfy all social groups, those who believe that they are disfavored or excluded from the policy field are motivated to challenge the dominant paradigm. Therefore, an alternative policy paradigm is more likely to "recruit" believers than a scientific paradigm is. The struggle between paradigms will be more often in a policy field than in a scientific community.

In short, like scientific research, a paradigm shift in public policy entails a crisis that shakes up the existing paradigm, outsiders or marginal actors who have the motivation for changes, and a new paradigm that can replace the old one. The lack of any of these elements may prohibit policymakers from challenging the status quo. When paradigm shift occurs, the policy field that connects ideas with legislation becomes the battlefield; once challengers can successfully reorganize the policy field and implement the new set of institutionalized beliefs the course of legislation will be changed.

2.3.6 Propositions

The following propositions are formulated based on the above discussion. The first set of propositions is around the impact of policy paradigm.

1a.When the jurist paradigm dominates the policy field, corporate finance will be repressed.

1b. When the neoliberal regime dominates the policy field, corporate finance will be substantially deregulated.

2a. When the jurist paradigm dominates the policy field, regulations for governance structure will concentrate on the internal allocation of the rights on corporate organs.

2b. when the neoliberal regime dominates the policy field, regulations for governance structures will concentrate on restraining the influence of insiders and promoting transparency.

3a. When the jurist paradigm dominates the policy field, the procedures and financial scheme of corporate restructuring is more likely be highly restricted.

3b. When the neoliberal paradigm dominates the policy field, the procedures and financial scheme of corporate restructuring is more likely be deregulated. Corporate restructuring is more likely to be encouraged.

The second set of propositions is around the conditions of the persistence and shift of policy paradigm

4a. A dominant paradigm is more likely persist when the policy field faces no crisis.

4b. Paradigm shift is more likely to occur when the policy field faces crisis.

5a. A dominant paradigm is more likely persist when the composition of the policy field does not change

5b. Paradigm shift is more likely to occur when new actors enter the field or marginal actors gain control.

Ch.3 Regime Shift: From the Jurist Regime to the Neo-liberal Regime

In this chapter, I will discuss the transition of policy regimes of corporate legislation in Japan. Because corporate legislation is a technically complicated issue, it is difficult for lawmakers to form the policy proposal by themselves. They often have to rely on scholars and bureaucrats who have professional knowledge to create the bills. Thus, the critical issues are who are involved and what ideas are employed. Before the 1990s, corporate legislation was largely controlled by law scholars in leading universities and bureaucrats in the Ministry of Justice (MOJ), who were generally promoted from working as prosecutors and professional judges. Their world view inevitably shaped the direction of corporate legislation. On the other hand, after the mid 1990s, economic bureaucrats in Ministry of International Trade and Industry (MITI; after 2000 became Ministry of Economics, Trade and Industry, METI) gradually challenged MOJ and provided a new paradigm of corporate legislation. They saw corporate legislation as an economic issue and treated a corporation as a nexus of contracts. The Japanese economic crisis and political turmoil triggered the regime shift and led to a new direction of corporate legislation. In what follows I introduce the policy field and paradigm of the jurist regime.

3.1 Historical Background of Japanese Corporate Law

Table 3: Historical Background of Japanese Corporate Law

Year	Event
1898	Commercial code was drafted by law scholars and passed by the Diet
1938	Limited liability was introduced
1949	Under the instruction of GHQ, board of directors was introduced and the power of monitoring was removed from auditors
1974	Auditor' power of monitoring was retrieved. Diet reached a resolution for a thorough reform of corporate law
1980	The proposal of corporate legislative reform was publicized. This proposal instructed the legislation in 1981, 1991 and 1993
1997	First "Diet member legislation" of corporate law in Japanese history
2001	The proposal of "modernizing corporate law" was publicized
2006	The reform package was passed and corporate law was formally separated from commercial code

The formation of Japanese corporate law was part of Japan's Meiji modernization. It was first formed in 1898 by transplanting the German system. Many corporations emerged during the economic boom after World War I, resulting in many unexpected problems. To cope with them, the Japanese Diet passed a series of amendments that established the corporate regulatory system in 1938. The critical element of the modern corporation— limited liability — was formally introduced into Japanese commercial codes in this amendment. The Japanese economy in prewar Japan was largely

dominated by large business groups controlled by a small number of families. The fascist government that arose in the 1930s tried to cooperate with and constrain the power of *Zaibatsu* families at the same time. On the one hand, many *Zaibatsu* families actively joined the overseas expansion with the militarist governments and obtained substantial interests. On the other hand, the fascist government also actively curtailed the power of *Zaibatsu* family and tried to control the corporations. The National Mobilization Law passed in 1938 prohibited strikes and layoffs. The Munitions Industry Law passed in 1941 endowed the government with the power to directly command managers without the consent. Corporate law, which prioritizes shareholder ownership, was virtually frozen in this process (Johnson 1982; Hoshi and Kashyap 2001; Kitazawa 1998; Suzuki and Takeuchi, 1981; Asaki 1999).

U.S. occupation after WWⅡ resulted in the first systematic change of Japanese corporate law. When Japan was defeated, *Zaibatsu* families originally expected GHQ to abolish the rules imposed by the fascist government and reinstate their full control over corporations. However, because U.S. occupational authority believed that large Japanese corporations were accomplices to invasions, it launched a series of reforms targeting the Japanese corporate regulatory system, including the dissolution of *Zaibatsu* and the overhaul of corporate law. They forced *Zaibatsu* to dissolve, required the leading families to release their shares and purged these companies of their senior managers, who were considered as collaborators with the fascist government (Dower 1999; Hoshi and Kashyap 2001; Miyajima 1985; Johnson 1982).

In addition to dissolving *Zaibatsu*, GHQ also actively adjusted Japanese corporate law based on the American model. The amendments in 1949 contained the following changes. First, in terms of corporate finance, the new corporate law established the institution of authorized capital. In the prewar corporate law, all shares written in the corporate constitution had to be issued during the incorporation. The new corporate law allowed new corporations to issue only 25 percent of the shares written in the corporate constitution and authorize the board of directors to issue the remainder in the future. This move gave the corporation more flexibility to manage the financial capital. Accompanied by the introduction of authorized capital, the preemptive right to buy new shares was also introduced in Japanese corporate law.

Second, the allocations of rights among corporate organs were substantially changed. In prewar corporate law, the general meeting of shareholders was in charge of most of the important decisions. Directors executed the decisions made by general meeting of shareholders and were monitored by auditors. The amendments in 1949 substantially altered this arrangement. First, the power of the general meeting of shareholders was significantly reduced. The general meeting of shareholders only retained the power of appointing directors and auditors, and important decisions. Second, the power of auditors was also reduced. Their power of monitoring executive affairs was removed, and they retained only the power of accountants. Third, the board of directors was institutionalized and became the center of decision making and monitoring. In GHQ's original design, the board of directors elected the representative

directors who served as the executive branch of the corporation. Third, the power of individual shareholders was expanded. Although the power of the general meeting of shareholders was reduced, individual shareholders were granted more rights in corporate law. These rights included the right to inspect corporate accounts, the right of derivative actions, the right to propose the dismissal of directors, and so on. (Kando, 2003; Kansaku 2000; Suzuki and Takeuchi 1981; Nakahigashi 1999).

It is widely agreed that although GHQ intended to enhance shareholders power, they unexpectedly strengthened managerial power in Japan. Dissolution of *Zaibatsu* and the purge significantly curtailed the power of blockholders who controlled large corporations in the prewar period. This power vacuum was soon filled by young managers. Additionally, although in GHQ's original design the board of directors served the function of monitoring the executive branch, it soon became the highest organ of the executive branch. Accompanied by the removal of power from the general meeting of shareholders and auditors, an institutional vacuum for monitoring emerged. Although the new corporate law expanded shareholders rights, the high threshold of exercising these rights prohibited the possible monitoring provided by individual shareholders (Miyajima, 1985; Hoshi and Kashyap, 2001). Even today, Japanese managers hold stronger control over corporations than their counterparts in any other advanced capitalist country (Gourvitch and Shinn 2005)

The corporate legislations between 1949 and 1970 were largely the extension of the 1949 reforms. The 1955 amendments completed the rules of the preemptive right to buy

new shares introduced in 1949. The 1962 amendments updated the technical rules of corporate accounting. The 1966 amendments dealt with the rules of the transformation between par-value share and nonpar value shares, the preemptive right of buying new shares, issuance of new shares, and so on (Hamada 1999; Mori 1999; Tokawa 1999). Not until the mid 1970s did corporate legislation was used as a means to deal with corporate governance problem. In what follows I introduce the corporate legislative reform between 1974 and 1990.

Table 4: Comparison of the Legislative Regimes

Item of Comparison	Jurist Regime 1974-1997	Neoliberal Regime 1997-2006
Composition of field	MOJ Bureaucrats with background of professional judges or prosecutors (in Civic Bureau), Law scholars trained in civil law tradition	Young generation of MITI bureaucrats (in Industrial Policy Bureau), neoclassical economists, law scholars specifying in American commercial law
Theoretical Roots	Civil law tradition	Law and economics
Nature of a corporation	An association composed of stable shareholders with purpose of profit seeking	A nexus of contracts that are constantly negotiated in markets
Corporation and society	A quasi-public institution that has great impact on social order	A private institution whose major connection with society is wealth maximization
Corporate Finance	Corporate finance is treated as a potential source of turbulence; restrictive requirements tend to be imposed	Corporate finance is treated as a positive way of increasing shareholder value; the regulations tend to be deregulated
Governance structure	The principle of governance structure is functional division among corporate organs.	The principle of governance structure is reducing informational asymmetry

	Shareholders are protected by internal check and balance among different organs.	between insiders and outsiders; shareholders are protected by board independence and informational disclosure
Corporate Restructuring	Corporate restructuring is treated as a special event with potential harm to small shareholders and creditors; restrictive requirements and procedures tend to be imposed	Corporate restructuring is treated as a positive measure that can increase shareholder value; the regulations tend to be deregulated

3.2 The Jurist Regime and the First Wave of Corporate Legislation

3.2.1 The composition of policy field in the Jurist Regime

Before 1993, Japanese corporate legislation was largely dominated by the community of law scholars serving in the Legislative Council (*Hōseishingikai*, 法制審議会) and bureaucrats in MOJ. Legislative Council is established in accordance with Article 57 of the Justice Ministry Organization Ordnance. Legally speaking, the Legislative Council merely serves as the consulting organ for the Minister of Justice. However, it actually owned the veto power on bills and was often involved with the process of bill drafting. It was arguably the most powerful policy council across ministries. Before the year 1997, no single piece of corporate legislation (and other bills related to fundamental laws) was passed without the approval of Legislative Council (Ueda, 2002). Although representatives from the business community were also appointed as members of Legislative Council, their voices were relatively marginalized in the legislative process. The division of commercial law was in charge of the corporate legislation.

The power of Legislative Council comes from scholars' role in the founding of the modern Japanese legal system. Law scholars were the architects of the modern Japanese legal system and enjoyed great respect; they also self-consciously undertook the responsibility of establishing and refining the law (Harley, 2001). The modern Japanese legal system was transplanted from the European Continental countries. In 1880, the Ministry of Justice hired German scholar to assist in the formation of commercial codes. In 1890, the first generation of Japanese law scholars already had the ability to draft codes. The Japanese commercial code was written by leading law scholars in Tokyo University. Politicians influenced this process very little. Since then, law scholars, especially those who served in the Tokyo Imperial University had a great influence on legislation. They directly negotiated with business groups to amend commercial code. The structure of the Legislative Council generally overlapped with the leadership of academics. The chairs of different divisions of the Legislative Council were generally the leading law scholars in major universities, especially in the University of Tokyo (Hamada, 1999).

MOJ bureaucrats also played an important role in corporate legislation. MOJ bureaucrats' power came from the following sources. First, as Johnson (1982) indicates, the ambiguity in Meiji constitution led to the autonomy of Japanese ministries. Because the commander of ministries was the Emperor, not the Prime Minister, there lacked a clear central political organ controlling all the ministries. This created the tradition of independent operation. Second, like other ministries, MOJ officers are stringently

protected by civil service laws and enjoy great autonomy in promotion. Most of the bureaucrats in charge of bill drafting were promoted from professional judges or prosecutors. Similar to other countries with a civil law tradition, Japanese judges and prosecutors are selected from national examinations. Most young judges and prosecutors are first assigned to local legal branches and look for promotion within the judicial system (Harley 2001). After service in the local legal branch, some young judges and prosecutors may choose to enter MOJ as the track of promotion. After entering MOJ, young officers served as apprentices for senior officers who are in charge of bill drafting. This apprenticeship may continue for several years until these young officers become promoted. The biography of Inaba Takeo, a retied officer who was in charge of corporate legislation in the late 1980s, can best represent this route of promotion. Graduating from Kyoto University in 1960, he served as an assistant judge in the Tokyo district court for 15 years. He entered the Civic Bureau and was promoted as leading officer in 1985 (Who is who in Japan, 1994). He described the process of training:

"We first served as apprentices of the senior officers and received the training of bill-drafting. Usually this training can continue for more than ten years. The training is concentrated on two issues. The first is to be familiar with the details of the whole legal system. The most difficult part is to make sure the bill is coherent with other laws. If it is not, often we need to draft more bills to maintain the cohesiveness. The most difficult issue is to prevent business groups from abusing the institutions. In the apprenticeship, we spent a lot of time simulating the tricks that may be adopted by corporations. We

learned to tell whether corporations truly need the law or they try to find legal loophole to avoid regulation. The training helped us keep cautious after undertaking the reasonability to bill-drafting."[1]

In addition to the historical origins, the political isolation of MOJ also helped to preserve its autonomy and internal cohesiveness. First, elected politicians generally lack interest in juridical affairs. As I mentioned earlier, elected politicians in Japan are notorious for having particularistic ties with ministries in exchange for resources for re-election. This type of relationship occurs most often in ministries that own the great power to allocate budgets, such as Ministry of Agriculture, Ministry of Finance and so on. The field of juridical affairs is not a field that can generate benefits for constituents. As a result, MOJ bureaucrats remained in a relatively isolated community of which the social ties are limited to professional judges, prosecutors and law scholars (Hōkai 法界). Therefore, almost no politician could be labeled as "Tribe of Ministry of Justice" (Homuzoku) (Nakajima, 2004). The isolation helped MOJ keep its autonomy and maintain the influence of law scholars.

Finally, the technical complexity and requirement of coherency also help to maintain the autonomy. One of the most important tasks for the Legislative Council and MOJ bureaucrats is to examine whether a bill is consistent with other laws. Given the poorly equipped staffs of the Diet, it is almost impossible for any elected politician to form an internally coherent bill without the assistance of professional bureaucrats or law

[1] Interview with Inaba Takeo, 2006/06/17

scholars, even though many politicians owned degree of law. Lawmakers have to rely on the professional knowledge provided by MOJ bureaucrats and law scholars. A senior member of legislative council, Egashira Kenjirō, explained the difficulty faced by lawmakers:

"A single piece of legislation generally results in the changes of hundreds items in other laws. Most lawmakers simply have no ideas about the potential influence to the whole legal system. If we don't amend another law at once, the completeness of the legal system may be hurt. When lawmakers try to bypass us, the first task is to find the staff who can undertakes this job. It is not easy."[2]

An indirect impact of the technical complexity is the lack of competing ideas outside the legal community. Corporate legislation was not noticed by other ministries and scholars from disciplines other than law before late 1980. In 1985, *Nikkei Shinbum* raised an interesting question: why hadn't any economist ever expressed an opinion on corporate legislation, which was supposed to be an important economic issue (*Nikkei Shibum* 1985/01/21)? Although economists did not necessarily defend business groups, this article highlighted the lack of alternative ideas framing the issue of corporate legislation. In addition to economists, economic bureaucrats also rarely showed any opinion in corporate legislation. In other words, the jurist regime monopolized the ideas of corporate law to a certain degree. During this period, the legal profession remained homogeneous in basic assumptions about commercial laws.

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[2] Interview with Egashira Kenjirō, 2006/07/20

On the other hand, although corporate legislation had a great impact on the economy, economic bureaucrats, who had much stronger power in Japanese politics, were not involved with it until the 1990s. In addition to the tradition of "horizontal division" (*tatewari* 縦割り), the dominant economic ideology of MITI during this period also contributed to this involvement. As Gao (1997) indicates, developmentalism is an "economics of industrialization;" what economic bureaucrats looked at was the competitiveness of specific strategic industries, not the abstract legal arrangements of the relationship between shareholders and managers. Furthermore, the first principle of corporate law, the shareholder sovereignty, contradicted with the dominant beliefs shared by economic bureaucrats that the state should substantially organize the industry. Therefore, economic bureaucrats were not involved in the policy field of corporate legislation before 1990s.

3.2.2 Policy Paradigm of Jurist Regime

The jurist paradigm in Japan can be best represented by the theory of corporate law of Suzuki Takeo (1905-1995), who was arguably the most influential scholar of commercial law in postwar Japan. His leadership in legislative council connected the prewar legal tradition and postwar corporate legislation. He first joined the deliberation of corporate law in 1930 when he served as an assistant professor of law in the Imperial University of Tokyo (University of Tokyo). After being promoted as a full professor in 1940, he became one of the leading scholars reviewing the amendments of commercial codes drafted by MOJ.

In addition to his position at Tokyo University, Suzuki's family background also enhanced his influence in law making. His grandfather was the founder of *Suzuki Shōten*, which was the leading trade company in prewar Japan. Several of his brothers also had high positions in Japanese business and political community. Suzuki Yoshio served as the director of Heavy Industry Bureau of MITI; Suzuki Osao served as the president of *Showa Denko* and the vice president of the Japan Association of Corporate Executives; Suzuki Masao served as the vice president of *Mitsubishi* Heavy Industries; Suzuki Hideo served as the director of International Finance Bureau of Ministry of Finance (Who is who in Japan, 1994). Although these personal ties did not necessarily play a direct role in Suzuki's service as a leading law professor, at least he is not an outsider of the circle of Japanese power elites. Furthermore, he was often criticized for being pro-big business by other law scholars (Okujima, 1994).

Suzuki's theory of corporate law had become the dominant version since the 1940s. Between the 1930s and mid 1940s, Japanese commercial law scholars faced a conflict between "economic law' and "commercial law." In the prewar context, economic laws referred to the rules entitling the state to manage the economy, such as the Important Industry Act, the National Mobilization Act and so on. Under the fascist economic regime, the state directly controlled management, and mandated firms to form and join association, but still left the nominal property right to the hand of shareholders. On the other hand, the basic assumption of commercial law is the full property right of owners. This conflict inspired an important debate about the legal status of shareholders and the

implications of their property right in early 1940s. Suzuki's mentor, Tanaka Kōtarō, argued that the shareholders rights in corporations should be limited to receiving dividends and should not extend to decision making and other rights (*Jiekiken* 自益権). On the other hand, Suzuki argued that shareholders should own the rights to participate in decision making and other executive affairs（*kyoekiken* 共益権）. Although Tanaka's theory was more consistent with the prewar economic ideology, Suzuki's theory won support from most commercial law scholars. Finally, Suzuki won this debate and the status of shareholders in Japanese corporate law was firmly established on the legal level (Suzuki, 1992; Kitasawa, 2001).

During the period of occupation, although Suzuki did not totally agree with GHQ's proposals, for the sake of retrieving Japan's sovereignty, he actively cooperated with GHQ, even though he felt uncomfortable about many amendments (Suzuki, 1985; 1992). Since the 1960s, he served as the president of the Association of Commercial Law *(Shōjihōmu Kenkyūkai,* 商事法務研究会*)* for more than thirty years and chaired the subcommittee of commercial code in Legislative Council from 1960 to 1994. His reputation and prestige as a law professor at the University of Tokyo helped to retain the authority of Legislative Council. Furthermore, because his theory of corporate law is the dominant version in the academy and national examination, other law professors and MOJ bureaucrats generally accepted his basic ideas about corporations. During Suzuki's term of division chair, leading MOJ bureaucrats in charge of corporate legislation tightly cooperated with law scholars in legislative council and shared the

vision of corporate legislation.[3] This composition of policy field had profound impacts on Japanese corporate legislation before the mid 1990s. In what follows, I introduce the problem of corporate governance between the 1970s and 1990s.

The beliefs of law professors and MOJ bureaucrats shaped the purpose and means of corporate legislation. Rooted in the assumption of civil law systems, the internal coherency of the legal system was one of the primary concerns during the deliberation. They were very uncomfortable with open-ended standards and adopted strict standards scrutinizing the potential deviance from legal logics. In the process of bill drafting and deliberation, law scholars and bureaucrats carefully simulated the possible legal loopholes and tried to prevent them in advance. Corporate governance problem is interpreted as one of accountability and order. Suzuki's (1981) statement in the introduction of corporate law can best represent this position. He suggested that in addition to the great economic benefits brought by the institution of corporations, corporations are also an important source of social risk. Suzuki warned that:

"Because the purpose of a corporation is profit, it tends to sacrifice others interest. Some sacrifice other stakeholders within the same corporations, while some sacrifice external creditors. The seriousness of the problem is contingent on the types of corporations. When members have closed relationships with each other, and when members undertake the responsibility toward creditors, the situation is better. On the other hand, when members of a corporation have no relationship with each other, and

[3] Shōhōshingi ni okeru suzukisenseiszō [Professor Suzuki in Amending Commercial Code], *Shōjihōmu* no.1422, 1996, p20-47

when members do nothing but contribute the capital, the situation is worse (Suzuki, 1981, p.2)."

Suzuki insists that although corporate law is categorized as private law, due to its great impact on society, corporations should be seen as quasi-public institutions. From this approach, managerial misconducts are a social malaise rather than the detriment of individual interests or efficiency. Corporate scandals not only include frauds or managerial self-dealing that hurts shareholders, but also include political scandals involved with big corporations, such as the Lockheed scandals and the secret payment to *sōkaiya* (a type of Japanese mafia who blackmail the managers by scandals). Members of the Legislative Council and MOJ bureaucrats often used the term "anti-social" to describe the corporate governance problem, and saw public trust toward the corporate system as the goal of legislation (e.g. Takeuchi, 1981, Motoki Shin, 1981).

On the other hand, a corporation is defined as a specific type of civil association with the purpose of profit seeking (営利社団法人 Eirishadanhōjin) (Ueyanagi, 1971). Although the argument that corporations belong to employees was popular in postwar Japan, it never became part of the policy paradigm of corporate legislation. Japanese corporate law asserted that a corporation belongs to its shareholders from the very beginning. The victory of Suzuki's theory in his debate with Tanaka further strengthened the principle of shareholder ownership in Japanese corporate law. In other words, the referred "members" in corporate law are limited to shareholders. This worldview is reflected in the vocabulary of old corporate law. Shareholders are the

"members" of a corporation. Similar to a democratic political system, directors are seen as the representatives of shareholders, and corporate governance relies on the voice from shareholders. The Japanese legal terminology referring to shareholders presents this worldview. In Japanese, two terms are applied to shareholders: *kabunushi (株主)*, which literally means the owner of the share, and *shain(社員)*, which literally means a member of the corporation. Although in everyday language, *shain* refers to employees, in corporate law it refers to a shareholder. Two golden rules of corporate law are derived from this assumption: equal treatments of shareholders (*Kabunushi Byōdō genzoku* 株主平等原則) and the principle of sufficient capital (充実資本原則). Equality treatment of shareholders is referred to as the rule that each share in a corporation should own the same rights and interests. The principle of sufficient capital asserts that corporations should maintain a certain amount of capital to protect the creditors.

The idea that a corporation is an association shaped the conceived solution of the corporate governance problem. Hirschman (1970) indicates two major ways to deal with failed organizations: voice or exit. Voice is defined as the attempts to change objectionable affairs through petition or challenge to the management, while exit is defined as the escape from dissatisfactory management. Democratic politics generally assumes the significance of voice, while market institution generally assumes the significance of exit. The jurist regime favors voice; "shareholder democracy" is the guiding principle for organizational design (Morimoto, 1995; Ochiai, 1996). Managerial misconduct was perceived as the result of an uneven distribution of power among

organs of corporate body and thus the conceived solution is to strengthen the power of auditors and shareholders. This governance structure is the central issue for jurist regime.

For many law scholars and MOJ bureaucrats, the amendments orchestrated by GHQ in 1949 were one important institutional source of corporate scandals. The adjustment of auditor power exacerbated the problem of monitoring. On the one hand, the power of monitoring executions (*Gyōmu kansaken* 業務監査権) was moved to the hand of the board of directors. This act created an institutional vacuum for monitoring. On the other hand, although auditors were endowed with the power of accounting inspection, since there was no requirement for the qualification of auditors, managers could easily escape (Kojima, 2001). The limited legal power held by small shareholders also worsened this problem. The Japanese legal system generally discourages lawsuits (Harley, 1992); in the case of corporate law, shareholders were only allowed to take legal action against managers when the complaint fits into one of the existing categories of suits provided under the Japanese commercial codes. Small shareholders were also not entitled to inspect many parts of corporate accounts. Shareholders could only claim the realized profits as a dividend, while managers have complete authority on the decision about assets, unrealized profits and allocation of corporate resources (Shishido, 2000).

In terms of corporate finance, for the jurist regime the protection of shareholders and creditors lies in ensuring that the sustainability of a corporation. The core principles of corporate finance are the legal concept of capital. The book value of capital, which is

the summation of the par values of issued shares, must be recorded in the corporate constitution. The concern for sufficient capital plays a central role in regulations for corporate finance. Corporations are supposed to maintain assets to the amount of book value capital throughout its incorporation, operation and liquidation to protect the creditors and shareholders. Corporations are not allowed to reduce its book value recorded in corporate constitution unless they pass through strict procedures. Jurist regime is extremely cautious in whether certain new practices of corporate finance would be manipulated to hurt shareholders and creditors' interest. It insists that corporate finance must be based on the legitimate purpose and should not endanger the sustainability of cooperation. These assumptions inevitably lead to a relatively conservative attitude toward corporate finance (Morimoto, 2001).

Third, jurist regime also held a conservative view toward corporate restructuring, especially its financing scheme. The priority of mandatory organizational rules and a conservative attitude toward corporate finance also had a significant influence on the rules of corporate restructuring. The jurist regime allowed only cash as the financial scheme for restructuring, a rule that significantly restrained the development of market for corporate control. The old corporate law also required the proposal of restructuring to pass the general meeting of shareholders. The market for corporate control was not encouraged in the jurist regime.

This regime shaped Japanese corporate legislation until the mid 1990s. However, the new legal thinking had emerged and finally replaced the jurist regime in the late 1990s. In what follows, I discuss the regime shift in the 1990s.

3.2.3 Corporate Legislation between 1974 and 1990

During the first wave of corporate regulatory reform between 1974 and 1990, the Japanese model of corporate governance gradually became mature. The so-called Japanese model contained the following elements. First, shareholders were extremely marginalized. The general meeting of shareholders almost performed no function in corporate governance Many big corporations chose the same day to call for annual general meeting of shareholders and the meetings were generally no longer than one and a half hours. Second, the board of directors was mostly composed of salaried managers. A corporation is seen as a community composed of employees rather than the property of shareholders. Core employees (正社員) enjoyed the guarantee of job security until a certain age and owned a certain amount of informal power in decision making. Third, the business network was a prominent phenomenon in the Japanese economic system; Japanese corporations widely used networks to maintain job security, raise funds, coordinate production, exchange information and share risk. The cross share holding in the networks significantly reduced the pressure from the capital market and consolidated their control. Fourth, most of the outside funding came from the banking sectors that were highly regulated and protected by the government. Equity finance was marginalized in corporate finance before the 1980s. In the 1970s, more than eighty

percent of external funding came from the banking sector. Corporations generally established stable relationships with specific banks, namely the main bank system. The main banks not only provided funds but also had a substantial role in corporate governance. They often sat in boards, disciplined managers, and were involved with decision making. The banking sector was the only agent performing the function of monitor (Miyajima, 1985; 1998; Hoshi and Kashyap, 2001; Aoki and Dore, 1994).

Despite the successful economic growth, this model could not prevent managerial misconducts. Although the Western world did not notice the managerial misconducts in Japan until the bubble burst in 1990, corporate scandals had already become a serious political issue in the early 1970s. A series of corporate scandals had been erupting since the mid 1960s and had brought strong political pressure on the LDP regime. In 1965, Sanyo Steel Inc., one of the major steel makers in Japan, found it unable to pay off the debt of 50 billion yen and filed for bankruptcy. The mass media later found that its management team had already covered the loss for several years. In 1972, Public Prosecutor charged Sanko Steamship Inc. for illegally taking over Japan Line steamship Inc. by bribing right wing politicians and mafia. In 1975, it was also found that the Mitsui Mining Company had illegally bought back their shares from the open market and faced a lawsuit (Okumura, 1975). In 1976, ex-Prime Minister Tanaka Kakue was found to have received bribes from the Lockheed Corporation.

In addition to these big scandals, the mass media often revealed that many corporate leaders regularly paid money to the mafia (*sōkaiya*, 総会屋) to cover their

scandals (Inaba, 1978). These corporate scandals brought great political pressure to LDP who had already suffered from environmental problems. LDP lost many local governments to the hand of environmental activists and faced an unprecedented crisis in early 1970s (Broadbent, 1998). Therefore, the leading LDP politicians were extremely sensitive to the political impact of corporate scandals. To cope with the crisis, politicians turned to law scholars and MOJ to strengthen the corporate regulatory system. In 1974 the Diet passed the amendment that reinstated auditors' power to monitor executive affairs. This amendment marked the beginning of the new wave of corporate legislation for two reasons. First, this was the first postwar legislation that deviated from the course set up by the occupational authority in 1949; it granted auditors the legal power removed by GHQ in 1949.

Second, during the Diet deliberation, Diet members showed strong concern over the corporate scandals that had been erupting since the mid-1960s, and passed a resolution for a comprehensive overhaul of corporate law. In other words, it was the first time that corporate governance was perceived as a problem in Japanese politics (Motoki, 1976). In 1978, the Minister of Justice, Furui Yoshime also personally asked Suzuki Takeo to strengthen the corporate regulatory system to revive the public trust toward the market economy. He was worried that disappointed voters may turn to the Socialist Party, which would lead to a more interventionist policy (Suzuki, 1981). Based on the formal authorization from the Diet and an informal request, the Minister of Justice declared a guideline that structured the corporate legislation in the next two decades.

The ideational approach suggests that what really matters in the legislative process is not the problem per se, but the problem perceived. For law scholars in Legislative Council and MOJ officers, these problems were only the symptom of the systematic problems created by the 1949 amendment instructed by occupational authority. They captured this opportunity to implement their version of corporate law. The Ministry of Justice identified seven priori issues for corporate legislation: 1. Corporate social responsibility, 2. Rules about auditors and directors, 3. Rules of general meeting of shareholders, 4. Rules of shares, 5. The disclosure of corporate accounting, 6. Corporate divesture and merger, 7. The requirement of minimum capitalization and the differentiation of big and small corporations (Suzuki, 1981). What is noteworthy here is that the scope of this guideline was far beyond the issues of managerial misconducts. Although the issues of corporate social responsibility, rules about auditors, board of directors and general meeting of shareholders, and the disclosure of corporate accounts were related to the prevention of corporate scandals, minimum capitalization, corporate divesture and merger, the rules of shares had nothing to do with corporate scandals that were the priori concerns for politicians. After collecting opinions of law scholars, business groups and other legal professionals, MOJ declared a proposal of legislation in 1980. The legislation in 1981, 1990 and 1993, and the previous legislation in 1974 was largely consistent with this guideline. These legislations will be discussed in the later chapters (Kitazawa, 1999).

The amendments before 1990 were based on this resolution. The Ministry of Justice (MOJ) formed a legislative team and publicized the project of corporate legislative reform (*kaishahō kaisei shian yoko*会社法改正試案要綱) in 1980. Based on this project, MOJ submitted amendments in 1981 and 1990. In 1981, the institution of auditors was further strengthened: large corporations were required to appoint at least one regular auditor who monitors operations and one accountant auditor who inspects corporate accounts. Auditors were also granted stronger power to inspect and punish directors. Shareholders were granted stronger power to inspect corporate accounts, submit proposals, and vote in absence in general meeting of shareholders. Corporations were also forbidden from paying outside mafia groups (*sōkaiya* 総会屋)[4]. During the 1980s, an important focus of corporate legislation was the requirement of minimum capitalization. Because in Japan the majority of registered corporations are small- and medium-sized enterprises owned by families, the MOJ was worried that these corporations could abuse the limited liability. The purposes of minimal capital requirement involve providing a basic guarantee for creditors and preventing irresponsible management (*Nikkei Shinbum* 7/08/1985). When this issue was first raised in the mid-1970s, it stirred strong opposition from small and medium enterprises, who were the major constituencies of LDP in local elections (*Nikkei Shinbum* 10/25/1985). However, MOJ bureaucrats saw minimum capital requirement as the priority issue and continually pushed for it. They finally convinced

[4] *Sōkaiya* is a scandalous but widespread phenomenon in Japan. It refers to the mafia groups who obtain some scandals of the leading managers and use these scandals to blackmail them. *Sōkaiya* generally threaten the corporations for disclosing the scandals in the annual general meeting of shareholders in exchange for money.

the LDP leadership to pass it in 1990. In 1993 the powers of individual shareholders and auditors were further strengthened.

The other issue of the period was the moderate deregulation of corporate finance. Under the coordination of the Ministry of Finance, corporate finance was also deregulated during this period. The most important measures were the deregulation of convertible bonds and warrant bonds. Convertible bonds refer to corporate bonds that can be transformed to shares in certain circumstances. Warrant bonds refer to corporate bonds that can be transformed to subscription of new shares. Convertible bonds were first legalized in the 1930s, but their issuance had to be passed by the general meeting of shareholders. This requirement virtually restrained their issuance. In 1974 the power to issue convertible bonds was shifted to the board of directors. Warrant bonds were also legalized in 1981. These two measures were widely viewed as the important step in financial liberalization. However, strict procedural and substantial requirements were imposed on the issuance of warrant bonds (Vogel, 1997).

3.3 The Process of Regime Shift

3.3.1 Political Turmoil, Structural Reform and the Rising Concern for Corporate Governance

As I mention earlier, crisis is a crucial element for paradigm shift. The regime shift began in the early 1990s when the Japanese economy faced an unprecedented crisis in postwar history. The critical but often overlooked development in corporate legislation in the mid 1990s (1993 -1997) is its formal incorporation into the project of structural

reform. The regime shift occurred amid unprecedented economic and political turmoil in postwar Japanese history. In the late 1980s Japan experienced bubbles in the land and stock markets. The institutional structures that successfully mobilized capital for development created room for speculation in the new environment of financial globalization. During this period large corporations actively shifted their sources of funding to the capital market. Many large corporations continued to raise money through the stock market and were heavily involved in speculation of lands and stocks. As they shifted their source of outside funding to direct financial markets, the banking sector lost its capacity to monitor, and was forced to lend to those with weaker credit histories or to small- and medium-sized companies. Stock and land prices increased to unprecedented levels, and the bubble finally burst in 1989. In the 1990s Japanese economy faced unprecedented crises: economic growth was close to zero between 1991 and 2003; several Japanese financial institutions went bankrupt as a result of the bubble's collapse. Many Japanese industries also lost their competitiveness that had seemed unstoppable in the 1980s (Gao 2001; Hoshi and Kashyap 2001).

Additionally, Japanese politics experienced unprecedented turmoil since the early 1990s. In 1993 LDP, the incumbent party since 1955 lost the cabinet to the alliance of eight political parties. Some observers of Japanese politics called this the first regime shift since 1955 (Pempel 1998). Despite its historical significance, this "regime shift" lasted for less than two years. In 1995 LDP regained control of the cabinet by allying with their long-term rival, the Japanese Socialist Party. In 1996 LDP regained full control

of the cabinet and Hashimoto Ryutarō assumed the office of Prime Minister. Although LDP lost power in less than two years, the movement of structural reform that emerged during this period had become the dominant theme in Japanese politics. Hashimoto launched the "big bang" reform that aimed at radically transforming the Japanese financial and administrative systems. However, the 1997 Asian financial crisis hit the Japanese economy again, and LDP was defeated in the 1998 election for House of Chancellor. Hashimoto was forced to resign. Chaotic politics and the recessive economy paved the way for the rise of Koizumi Junichirō. By portraying himself as the true vanguard of structural reform, Koizumi unexpectedly defeated Hashimoto, who held the support of all the major factions in the LDP, and became prime minister in 2001 (Mulgan, 2003; Sakakibara, 2003).

The calls for structural reform triggered by economic recession and political turmoil strengthened MITI's challenge to the policy field of corporate legislation. In July 1993, the first non-LDP government after 1955 was formed by the alliance of eight parties (Pempel, 1998). During this period, the Japanese economy was stagnant and the traditional fiscal policy failed to stimulate the economy. The voice that Japanese faces structural problem became stronger in the political sphere. Right after the establishment of the first non-LDP government, Prime Minister Hosokawa organized the Research Group of Economic Reform (*Keizaikaikakukenkyūkai*) that was composed of business leaders, scholars and leading bureaucrats to provide economic strategy. Its final report, which was known as the Herai report, was published in 1993.

This committee marked the beginning of the movement of structural reform in an unexpected fashion. Although its report did not provide any fresh ideas in the Japanese economy, two economists in this group, Oda Hiroko and Nakatani Iwao, publicly criticized bureaucrats for manipulating this research group for their vested interests and provided their own solution to the Japanese economic problem. They argued that Japan's economic recession has a deeper root in the over-regulation and rigid corporate governance that leads to low competitiveness. The only solutions to revive Japanese economy were radical deregulations and encouraging market competition (Nakatani and Oda, 1994). Prime Minister Hosokawa accepted this argument and the ruling allies passed the laws to establish the Commission of Administrative Reform *(Kyōsei kaikaku iinkai*) that was bestowed with the legal power to examine regulations in all fields. Although the Hosokawa cabinet only survived for nine months, their vision of reform was further strengthened in later policy development. Nakatani was only one example of the rising influence of neo-liberal minded scholars in Japanese economic policy. As Ikeo (2001; 2006) and Gao (2003) indicate, during the economic recession, many Japanese lost confidence in the Japanese economic system and eagerly looked for a solution. Neo-classical economists, who were marginalized in the past rapidly, gained influence in policymaking.

The end of the short live non-LDP government did not stop the movement of structural reform. On the contrary, LDP politicians also actively promoted structural movement to appeal to the voters. In 1995, the LDP re-controlled the government by

allying with the Japanese Socialist Party. Nevertheless, they also accepted the argument that Japan needs radical reform and established the Commission of Administrative Reform. The most important subunit for corporate legislation within the commission is the Subcommittee of Deregulation (*Kiseikanwa shōiinkai*) that included reform-minded entrepreneurs and economists, including Nakatani Iwao, Oda Hiroko, Miwa Yoshiro, Iwata Kikuo, Horiuchi Akiyoshi, Honma Masaaki, and Ito Motohisa. Most of these scholars were trained in neo-classical economy and held strong faith in the free market. They shared Nakatani's argument that the Japanese economic crisis had a deeper root in the institutional structures than in the business cycle. The final report proposed radical deregulation to save Japanese economy. Based on the resolutions of the subcommittee, the final report was drafted by MITI bureaucrats and passed as a cabinet resolution in 1996[5].

Although corporate legislation was merely one small part of these reports and action plans, it nonetheless brought the ideas of neo-liberal paradigms into corporate legislation. First, the discourse that Japan suffered from over-regulation helped to justify business groups request for deregulation. The detailed rules and cautious procedures established by MOJ and Legislative Council were now interpreted as a source of recession and became the target of reform. The role of corporations shifted from the potential violators of law to the victims of rigid regulation. Second, as corporate governance became part of the structural reform, the purpose of corporate legislation

[5] The informal version of this report was first published by MITI in early 1996. This report was not publicized and was only distributed among ministries. The formal version was later published by the Cabinet. The archives show that these two versions are identical.

had shifted to economic performance. This changing cognition legitimized the challenge to the old regime. Through this process, the power of agenda setting was gradually shifted to the advocates of structural reform, especially economic bureaucrats and politicians. MITI became more aggressively involved in corporate legislation (Nikkei Shinbum 1995/07/13).

This vision of structural reform had a profound impact on later economic policy. Nakatani actively advocated the American style of corporate governance and was appointed as the chair of Commission of Economic Strategy during the Kobuchi cabinet (1998-2000). The strict regulations for corporate finance are nothing but an extension of bureaucratic inertia. MITI also treated structural reform as the new paradigm of economic policy and was actively involved with corporate legislation. The deregulation of corporate regulations constantly appeared in reports of economic strategy. In 1997, the cabinet resolution of the Three Year Plan for Deregulation (*Kiseikanwa sankanen keikaku)* mentioned the deregulation of share repurchase, corporate bond and share exchange (Naikakufu 1997). In 1998, the Action Plan for the Transformation of Economic Structure and Innovation (*Keizai Kozo Hankaku ro Sozo no tame no kodo keikaku*) also included corporate legislation (Naikakufu 1998). In 1997, MITI published the economic plan, Innovative, Reformative Corporate Governance (*Sozo, kakushikata Koporeto Gavanasu*) and emphasized the importance of corporate governance and legislation (Tsusanshō 1997).

3.3.2 Breaking the Jurist Regime: the Deregulation of Stock Option in 1997

The most important event of this "regime shift" was the deregulation of stock options in 1997 during the Hashimoto cabinet. In 1996, the LDP won the general election and *Hashimoto Ryotarō* assumed the role of Prime Minister. After 1997, the policy field of corporate legislation was further dismantled by the alliance of economic bureaucrats, business groups and elected politicians. Law scholars serving in the legislative council, who were once seen as the vanguard of the Japanese legal system, were blamed for obstructing economic efficiency by elected politicians. The point of breakthrough for the policy field of was the deregulation of stock options, which was incorporated into the cabinet resolution in 1996. Elected politicians, allied with business groups and MITI bureaucrats, were impatient with the slow, deliberative process. Business groups and politicians accused the legislative council of treating corporate law as an aesthetical issue and therefore disregarding the reality (Nikkei Shinbum, 2000/09/18). In 1996, the LDP organized a special legislative team of corporate governance and proposed the deregulation of stock option. In 1997, two leading politicians of the LDP legislative team, Yasuoka Okiharu and Oda Seiiji, bypassed the Legislative Council and submitted the bill. Prime Minister Hashimoto also ordered MOJ bureaucrats to assist politicians for bill drafting.[6] This bill was first passed in LDP and later received unanimous support from all parties in the congress in early May (Yasuoka 1997). This act seriously angered the community of law scholars. On May 25th, two hundred and twenty five professors of

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[6] MOJ officer Yoshikai Shoichi revealed the order from the cabinet of assistance in *Shojihomu*, No.1479, p13, 1998

commercial law signed a public letter to protest this legislation. They argued that the politicians' actions obstructed the careful discussion and may have facilitated insider transaction and managerial expropriation.[7] Elected politicians responded by accusing the legislative council of wasting too much time and thwarting the recovery of the Japanese economy. The first politician-drafted amendment of corporate law turned out to be the conflict between politicians and law scholars.

This conflict marked the end of the jurist regime in Japanese corporate legislation. The perceptions of the corporate governance problem had shifted from insufficient regulations to over-regulation, while the proposed solutions had shifted from enhancing internal democracy to strengthening market mechanism. The cautious deliberation lost its legitimacy and was interpreted as bureaucratic inertia that hurt economic efficiency. Despite the endless corporate scandals in the 1990s, under the new ideational framework, corporations' status shifted from potential trouble makers to victims of over regulation. Yasuoka defended his challenge to the Legislative Council by addressing the emergence of Japanese economic conditions. He suggested that stock options can provide incentives for managers to improve Japanese corporate governance and thus strengthen Japan's competitiveness (Yasuoka 1997). Equipped with new

[7] See "'97nen shōjihōmu hairaito," Shōjihōmu, Vol.1478 p20. About the law scholars concern for stock option, see Okushima Takayasu, "Shōhō kaisei wa daikigyō henchō" [Commercial Law Reform Favors Big Corproations], Nikkei Shibum, (1997/05/14). Morimoto Shigeru, "Giin rippōni yoru sutokku opushon seido"[The stock option institution drafted by the politicians], *Shōjihōmu*,Vol.1459 (1997), p2-10. Uemura Tatsuo, "Sutokku opushun seido no hōdeki hyōka"[Evaluating the institution of stock option: a legal approach], Kigyōkaikei, Vol.49(1997) p26-32

institutionalized beliefs, the new pro-reform alliance had successfully been formed and had broken the jurist regime.

After this conflict, politicians were more confident in supporting the business community's request in corporate legislation. In October 1997, Oda Seichi cooperated with *Keidanren and* publicized Amendments of Commercial Law Related to Corporate Governance (*Koporeto kabanasu ni kansuru Shōhōto kaisei shian koshi*) to strengthen the Auditor system and raise the threshold for shareholder lawsuits. He attacked the Legislative Council for only representing the legal professions, which is merely an extremely small portion of Japanese citizens.[8] In 1998, the crash of the stock market brought by the Asian financial crisis created the urgent need for further deregulation of share repurchase. Responding to the request of the business groups, Yasuoka and Oda led the legislation, easing the restriction on the procedures and financing of share repurchase. Corporations were allowed to use capital reserve to buy back shares, and share repurchase only required the resolution of board of directors.[9] Between 1997 and 2001, Diet members drafted and passed eight bills related to commercial law, which was unprecedented in the Japanese political system (Ueda, 2002).

As the Legislative Council lost its veto power in corporate legislation, MITI gained a stronger position in legislation because of their better connections with political leadership. On the other hand, for politicians, MITI's involvement in corporate

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[8] Shojihomu 1470, p.4-p.11

[9] Iwahara Shinsaku, "Kinkyū taisaku toshite no heisei jūnen shōhō kanrenhō no kaisei"[Amendment of Commercial Law as the Emergent Economic Plan in 1998], *Shōjihōmu,* Vol.1492 (1998) p4-17

legislation also helped them justify their challenge to MOJ and reduce the uncertainty of policy. Since the purpose of corporate legislation had shifted from social order to economic efficiency and jurist regime can say nothing about the economic issue, they lost the authority to restrain politicians, business groups and economic bureaucrats. After this conflict, MITI actively promoted the deregulation of stock swamp, stock exchange and Spin-off Company, which are important for corporate restructuring and markets for corporate control.

3.4 Neoliberal Regime

3.4.1 Policy field of neo-liberal regime

The core actor of the neo-liberal regime is MITI (after 2000, it became METI). In 2006, two events shocked Japanese society. A star IT entrepreneur, Horie Takahumi, and a star fund manager, Murakami Yoshiaki, were contiguously arrested for insider transaction. Because they were once seen as the pioneers of a new type of corporate governance, their arrest inspired complex reactions in Japanese society. A renowned law scholar, Uemura Tatsuo claimed that this scandal is the inevitable outcome of "the METI[10] version of corporate law" (Uemura, 2006). Although this comment may not be completely fair, economic bureaucrats' great influence on corporate legislation in the last decade is indisputable. The neo-liberal regime of corporate legislation was promoted by the Ministry of International Trade and Industry (MITI), especially the Industrial Policy Bureau for one decade. As I mentioned earlier, Japanese economic bureaucrats were not

[10] In 2001, Ministry of International Trade and Industry (MITI) absorbed the Econominc Plan Agency abd changed its name to Ministry of Economy, Trade and Industry (METI).

involved with corporate legislation before 1990; therefore, why did they change their attitude toward corporate legislation in the last decade?

Since the late 1980s, MITI gradually shifted its economic ideology to a more market-friendly version. Although MITI was famous for its anti-competition orientation in the 1960s (Johnson, 1982), the young generation of MITI officers held a more positive attitude toward market competition than their predecessors had. This was due to three main factors. First, since the 1970s, neoclassical economics had been institutionalized in Japanese academy and thus influenced the young generation of bureaucrats. As Gao (1997) indicated, developmentalism is built on the economic philosophy of Marxism, Schumpeterian and German historical school. However, after the 1970s, these economic thoughts were gradually replaced by the neo-classical economics (Ikeo, 2004). Nokuchi Asahi, a historian of Japanese economic thought, has commented that when the Western scholars noticed the develomentalism, its underlying economic thoughts had already faded away in Japanese academy (Nokuchi, 1999). A landmark of MITI's acceptance of neoclassical economics was the appointment of Komiya Ryōtarō as the director of the Institute of International Trade and Industry (*Tsushō sangyō kenkyūshō*), the think tank for MITI in 1988. Komiya was among the most influential neoclassical economists in Japan and actively opposed the traditional anti-competition policies. The appointment of Komiya reflected the changing economic thinking in academia.

Second, beginning in the 1970s, MITI continuously sent promising officers to the U.S. for graduate studies. Although these young officers may necessarily not be

convinced of the superiority of the U.S. system, they nonetheless bear a very different world view from their predecessors and are more likely to accept U.S. institutions (Yaki, 1999; Dore, 1998; 2006). According to the White Book of Civil Servants (*Kōmuin Hakusho*), each year, MITI has sent more than ten young officers abroad for gradual studies since 1968. In the early 1990s, the majority of young MITI officers had the experience of studying abroad, especially in the U.S. Nakahara Toshihiko, a METI (MITI) officer who was in charge of the corporate legislation after 2000, described the impact of the American experience:

"Most of my colleagues have studied in the United States. I was sent to Cornell University to pursue a PhD in political science. I spent most of my time there in financial theories. I had never learned this kind of thing before and really felt that my eyes were opened in the classroom. Those senior officers had a hard time accepting these new ideas, but people in my generation face no difficulty accepting new things."[11]

Third, although big Japanese corporations were sticking to the traditional mode of corporate governance in their homeland, they did not hesitate to utilize the latitude of financial techniques in the U.S. (Kestor, 1992). MITI officers were well-informed about this trend and seriously considered incorporating these financial operations in their policy for industrial finance (Sangyō kinyū). These factors contributed to MITI's rising interest in American-style corporate finance. This can be best represented by the report of M&A policy published by MITI in 1991 (Tsusanshō 1991).

[11]Interview with Nakahara Yoshihiko, 2006/07/12

Fourth, despite their minority position, some young scholars of commercial law gradually embraced the American legal thinking and provided important intellectual resources for MITI.[12] Through this process, MITI officers gradually developed their expertise and developed an informal think tank in corporate legislation. Among these scholars, Kanda Hideki is arguably the most influential one in promoting a neo-liberal regime of corporate legislation. Like many other prestigious law scholars, Kanda was trained at, and served in, the University of Tokyo. However, since the late 1980s, he became the leading voice of American legal thinking in Japanese academy and an important consultant for MITI. In late 1987, he joined the Research Committee for Issues Related to M&A organized by MITI to survey the development of corporate finance in other advanced countries. In the 1990s, he strongly criticized the principles of traditional corporate law for inhibiting the development of a healthy capital market and proposed a more market-friendly corporate law. Although he does not necessarily agree with all legislation instructed by MITI, he nonetheless brought new legal thinking into the political process.

In addition to the internal transition, the transformation of the political environment also forced MITI to find a new position in economic policy. Traditionally, MITI played the "visible hand" to coordinate markets (Johnson, 1982; Okimoto, 1994). Despite its limited effects, the movement of administrative reform in the 1980s presented a strong challenge to MITI. Since 1983, Prime Minister Nakasone established the Provisional

[12] Interview with Nakahara, *ibid*

Commission on Administrative Reform (Gyōsei kaikaku shingikai; Gyōkakushin). Administrative reform became a popular theme in Japanese politics. Politicians constantly provide their plan of reform to attract voters. The Administrative Procedure Act passed in 1994 clearly granted the private sector the power to reject informal administrative guidance from bureaucrats (Carlilie, 1998). MITI greatly suffered from this trend. Compared with other ministries, MITI relied most on the informal intervention with the economy. MITI needed to find its new position in the new political environment.

Under the new political environment, both MITI's policy and organizations experienced significant transformation. MITI's internal units can be divided into two types: vertical units that target specific sectors or industries, and horizontal units that target general issues. The examples of the former include The International Trade Policy Bureau, and Industrial Policy, while the examples of the latter include Basic Industry Bureau, Machinery and Information Industries Bureau. According to Johnson (1982), the vertical units in MITI played a crucial role in the traditional style of industrial policy. However, during the 1990s the number and staff members of the vertical units were significantly reduced, while the staff members of horizontal units had significantly increased. Industrial Policy Bureau was the biggest winner in this reorganization. Accompanying with this process, MITI shifted the focus of industrial policy from targeting strategic industries to establishing general rules (Namura, 1999).

The internal transition and external challenge facilitated MITI's involvement with corporate legislation. As MITI bureaucrats gradually saw corporate governance as part of the economic policy, they began to challenge MOJ's authority on corporate legislation. The first challenge was the deregulation of share repurchase. In 1992, the director of Industrial Policy Bureau purposely invited business leaders and pro-reform scholars to organize the Research Group for Corporate Institution (企業法制研究会 *Kigyō hōsei kenkyūkai*). In 1993, this research group published a report supporting the radical deregulation of share repurchase (Nikkei Shibum, 1993/04/29). Nakahara Toshihiko, who served as a staff member of this research group, stated their purpose:

"The scholars in MOJ were too conservative to really think about the economy. They were sticking to some abstract legal principles and never considered the corporations need. Because it is difficult to change MOJ, we needed to present another voice about corporate legislation."[13]

This study group marked the beginning of the neo-liberal regime of corporate legislation in Japan. Although the issue of share repurchase was still dominated by the MOJ, MITI's action presented an unprecedented challenge to the policy field of corporate legislation in Japan. Throughout the 1990s, the Industrial Policy Bureau constantly organized the Research Group for Corporate Institutions to present their opinions about corporate legislation. When Kusakabe Satoshi, a MITI officer, summarized MITI's economic policy in the 1990s, he mainly mentioned the deregulation

[13] Interview with Nakahara, *ibid*

of the corporate regulatory system (Kusakabe, 2004). This reflected MITI's new position of economic policy in the 1990s. On the other hand, MOJ's role in neo-liberal regime experienced a radical shift after 2000. Before 2000, MOJ bureaucrats stood in the oppositional position to MITI. It wasn't until the 2000s that the MOJ was restructured by political leadership and became part of the neo-liberal regime. On the other hand, mainstream law scholars who believed in jurist paradigm were marginalized in the policy field of corporate legislation after 1997. In what follows, I introduce the new paradigm.

3.4.2 The Neoliberal Paradigm

The neo-liberal paradigm can be summarized as follows. First, for the purpose of corporate legislation, this regime sees corporate governance as an issue of economic policy whose end is economic prosperity. Economic efficiency, not stability, is the priori concern for corporate legislation. A statement made by Kanda Hideki best captures this assumption: "the purpose of corporate legislation is to improve competitiveness, to cope with IT revolution, and to help expand capital market (Kanda 2000). METI's report on Corporate Legal Institutions for the 21st Century, published in 2000, also addressed the need to cope with the new global economy dominated by financial capital as the major purpose of corporate legislation (Keisanshō 2001). In other words, the role of corporate law shifted to facilitating competitiveness.

Second, the neo-liberal paradigm sees a corporation as a nexus of contracts. This principle can be best captured by the statement made by Nakahara Yoshihoko, a METI

(MITI) officer who participated in corporate legislation after 2000. To defend METI's position in corporate legislation, he argued that the debate about who owns the company is seriously misleading. A joint stock company is a nexus of contracts, and the process of electing directors should be seen as the exercise of an appointment contracts (Nakahara, 2003). Thus the corporate governance problem should be understood as one of corporate or shareholder value, not one of "sovereingty". Literally, the shareholder value is referred to as the total capitalization of a company. The purpose of the corporate contract is to increase the shareholders' economic return. Different parties may form different types of contracts to reach this goal. Because parties in contract know better their own interests than the government does, restrictive regulation would only prohibit the optimal arrangements and hurt efficiency. Using Hirschman's (Hirschman, 1970) classification, unlike the jurist regime which favors voice within organizations, the neo-liberal regime favors exit as the solution of failed organization. Shareholders are not that different from a customer of ordinary products; when a corporation fails to produce enough profit for shareholders, the shareholders exit and the firm's stock price falls. When management is aware of shareholder's desertion, it must take an active role in repairing the damage to the corporation. Thus, liquidity is the central issue of corporate legislation under the neo-liberal regime. The best way to solve the corporate governance problem is to let shareholders vote with feet, namely, sell the stock. In the long run, this will raise the shareholder value and benefit the whole economy. Thus, establishing the price mechanism is the conceived solution to the corporate governance problem.

Unlike the jurist paradigm that is hostile to corporate finance, the neo-liberal paradigm holds a positive attitude toward corporate finance. Because the principle of corporate legislation shifted from ensuring the sustainability of corporations to maximizing economic returns for shareholders, raising stock price becomes a legitimate policy goal. Under the neo-liberal regime, financial techniques such as share repurchase, stock option, corporate bonds and a variety of special shares should not be seen as a threat but as an important strategy to raise shareholder value. The traditional principle of sufficient capital, which requires corporations to withhold a certain amount of capital, is seen as an obstacle of flexible financial market. From this paradigm, the best guarantee for creditors and shareholders interests is a healthy market. The stock and bond price provides sufficient information for shareholders and creditors to protect themselves. The government has no position to require corporations to maintain capital and intervene with the choice of financial strategies.

In terms of governance structure, unlike the jurist paradigm that emphasizes internal democracy, the neo-liberal paradigm focuses more on dismantling the market barrier than an internal distribution of power among corporate organs. Because corporations are not seen as associations but as contracts formed by shareholders and managers, parties in the contracts should own certain latitude to negotiate the optimal arrangements. Therefore, the neo-liberal paradigm allows corporations to form their own charters and allocate the rights among corporate constituencies. This move significantly reduces the mandatory features of Japanese corporate law and makes it

closer to the U.S.-style enabling corporate law. The focus of regulations for governance structures shifted to breaking the closed circle of decision making and ensuring that shareholders can receive what is in their best interest in important transaction. Therefore, the issues of independent directors are at the center of legislation. As Kanda (2006) indicates, governance structure is the field which shows clearest reverse course in corporate legislation. Under the jurist regime, the solution for the corporate governance problem is to impose more rules on governance structures. However, under the neo-liberal regime, the solution shifted to deregulating the rules and letting the market work.

In terms of corporate restructuring, the neo-liberal regime actively encourages market for corporate control and treats it as an essential mechanism for corporate governance. The neo-liberal regime significantly simplifies the procedures and allows corporations to adopt diverse financial schemes for merger and acquisition. The neo-liberal regime even tried to break two long term taboos among Japanese corporations. First, it encouraged foreign acquisition. In the past, Japanese governments and corporations made great effort to resist foreign capital and foreign acquisition. However, the neo-liberal regime asserts that Japan needs foreign capital to bring new management skills and technologies and deregulated triangular merger to introduce foreign capital. Second, the regulations related to hostile takeover were also loosened. Japan is among the industrialized countries that has the least number of hostile takeovers. However, the neo-liberal regime asserts that hostile takeover can discipline managers, reform failed corporations and adjust the industrial structures under the right rules and encourage

“healthy” hostile takeovers. Despite the great pressure from business groups, METI published the guidelines for the defending strategies against hostile takeover and insisted that the defending strategies should not hurt the markets for corporate control (METI, 2006).

3.4.3 The Institutionalization of the Neo-liberal Regime

Despite the vibrant politician bill drafting between 1997 and 2000, the institutionalization of the neo-liberal paradigm still entails the assistance of MOJ. The lack of staff and professional knowledge prohibited them from systematically amending corporate law. Although MITI provided the policy paradigm, it lacked the legal power and qualified staff to thoroughly amend corporate law. This deficiency made few problems in single legislation; however, without controlling MOJ, a systematic overhaul of corporate law is impossible. One of the politicians drafting the bill in 1997, Ueda Isamu, later admitted that politicians can only deal with single issues and, therefore, have difficulty dealing with the whole corporate law. They still have to rely on MOJ bureaucrats (Ueda, 2002). The fact that the deregulation of the stock option in 1997 was still assisted by MOJ bureaucrats confirms Ueda’s observation.

Since 2000, the policy field of corporate legislation had been further restructured through three paths. The first path is the transformation of Ministry of Justice. In 2000, Yasuoka Okiharu was appointed as the Minister of Justice, and Ueda Isamu was appointed as the Vice Minister. Because Yasuoka was appointed by Mori Toshirō, the least popular prime minister in postwar Japanese history, his contribution in corporate

legislative reform was often neglected. Although his term only lasted for seven months, Yasuoka made several important changes to restructure the policy field of corporate legislation. First, he changed the composition of the Legislative Council and established a strict time line for deliberation. He appointed economists, corporate lawyers and entrepreneurs as members of the Legislative Council. Oda Hiroko, a member of the Research Committee of Economic Reform and Subcommittee of Deregulation, was appointed as a member of the deliberative committee of juridical affaire in 2000 (Nikkei Shinbum, 2001/02/15).

Second, based on the resolution of Commission of Administrative Reform, in 2000, the Japanese government launched a "personnel exchange" program among ministries. Because the Japanese administrative system was vertically divided, the careers of bureaucrats highly depended on the reputation and interpersonal relations within their ministries; therefore, it becomes very difficult for officers from different ministries to cooperate. This program gave the Ministry of Economy, Trade and Industry (METI, ex-MITI)[14] a chance to directly influence corporate legislation. In 2000, METI published the report Corporate Legal Institutions for the 21st Century (Nijuiseiki no kigyokeiei no tame no kaisha hosei no seibi) as the guideline of corporate legislation. Through personnel exchange, Industrial Policy Bureau sent two officers who participated in Research Group for Corporate Institutions to Civic Affairs Bureau of MOJ to join the corporate legislation (Koriya 2006).

[14] In 2001 Ministry of International Trade and Industry (MITI) absorbed Economic Paln Agency and the name was changed to Ministry of Economy, Trade and Industry (METI).

Third, Yasuoka also exercised political leadership to appoint pro-reform officers as the director of Civil Bureau. He reduced the influence of officers with backgrounds of professional judges or prosecutors by expanding the staff of the Civic Bureau. In the past, only two to three officers with the background of a prosecutor or a judge had served as the staff for corporate legislation. In 2000, Yasuoka launched the project "Modernization of Corporate Law" to thoroughly amend corporate law and expand the staffs of Civic Bureau. In this process, Yasuoka appointed lawyers, accountants and scholars as the officers in charge of corporate legislation. Among the eleven staff members working on corporate law, five were former judges or prosecutors, four were lawyers, one was exchanged from METI and one was an accountant. In other words, less than half of the staff members had backgrounds of judges and prosecutors (Iwahara, 2006). This was unprecedented in the history of corporate legislation. Through this process, MOJ and the Legislative Council were totally incorporated in the neo-liberal regime.

These actions institutionalized the neo-liberal paradigm in the policy field. Through the officers exchanging from METI, the issue of corporate legislation was fully connected with the broader scheme of structural reform, which was the dominant economic policy during this period. The internal replacement of the Civic Affair Bureau also successfully restrained the opponents of the reform. Although the Legislative Council was still mainly composed of scholars believing in jurist paradigm, the strict timetable limited its role in deliberation (*Nikkei Shinbum*, 2001/01/18). Furthermore, after 1997, any bills of corporate legislation can easily bypass the legislative council through politicians. Even

the leading MOJ bureaucrats promoted by Yasuoka also bypassed the legislative council to draft the bills. Egashira Kenjiro, the chair of Division of Corporate Law of Legislative Council, found that many amendments submitted by MOJ to the Diet were never reviewed by the Legislative Council (Egashira, 2005). A METI bureaucrat sent to MOJ, Koriya Daisuke, also publicly suggested that because law scholars are not stakeholders of corporate legislation, their opinions are less important than those stakeholders, namely business groups (Koriya, 2005). In short, law scholars lost their traditional influence in the legislative process. Throughout the legislative process, the policy team in LDP played an unprecedented role in forming the draft. The tension between METI and MOJ generated in the 1990s was significantly removed. The two ministries turned their hostile relationship to cooperation.[15]

3.4.4 The Second Wave: Japanese Corporate Legislation between 1997 and 2006

Despite this political and economic turmoil, several amendments of corporate law were passed in the 1990s, including the 1994 deregulation of share repurchase and the enhancement of power of the auditors and the general meeting of shareholders. In 1997 stock options were deregulated, and in 1998 share repurchase was further deregulated. Accompanied by the deregulation of the shareholding company, the rules of corporate restructuring were also substantially deregulated between 1997 and 2000. These acts included the ease of procedural requirements, the establishment of the institutions of

[15] Interview with Nakahara, 2006. This development was also confirmed in the interview with Egashira and Inaba

corporate divestiture, and the deregulations of share exchange and domestic triangular merger.

The project "Modernization of Corporate Law" (Kaishahō Kendaika) marked the implementation of a new paradigm after the regime shift. After adjusting the internal structure of MOJ, in 2000, Yasuoka launched the project "Modernization of Corporate Law" to thoroughly amend corporate law. He declared three goals of the modernization plan: 1. strengthening competitiveness and corporate governance, 2. enhancing the efficiency, and 3. providing a more flexible scheme of corporate finance. Based on this project, the Ministry of Justice recruited more staffs and formed project teams to amend corporate law. In November 2003, the concrete proposal of corporate legislation was formed and began the review in legislative council. The bill was submitted to Diet in 2004, passed in 2005, and was implemented on May 1st, 2006. It is widely agreed that the modernization plan marked the biggest change in the history of Japanese corporate legislation.

Some parts of this project were purely technical issues that received unanimous support from all parties and scholars. First, corporate law is formally independent from commercial code. Before this legislation the status of corporate law was merely a chapter in the commercial code. Second, old-fashioned legal terminology, which has been used since the Meiji period, is replaced by contemporary language. Third, to cope with the development of digital technology, electronic meetings and documents are legalized (Hōmushō 2001).

In addition to the technical issues, the new corporate law substantially altered the basic logics of corporate regulation. First, the new corporate law gave corporations more latitude to choose governance structures and allocate the rights based on corporate constitution (定款自治). Second, the detailed rules on governance structures were eased. Corporations were given more latitude in forming charters and organizations. In other words, the principle of contractual freedom, which is essential in contract law, was now applied to governance structures. By the same token, the restrictions on the issuance of corporate bonds and special stocks were also eased. Large corporations were also allowed to abolish the board of auditors and adopt the American style of the one-tier board system if more than half of their directors were independent. The principles of capital, which was the principle restraining a variety of financial operation, was abolished. The accompanying restrictions on corporate finance were virtually removed. Corporations owned substantial latitude in the issuance of options, and it was formally recognized as a type of asset (Fujita 2002). Share repurchase was totally deregulated; the proposal for share repurchase only needed to pass the board of directors and faced no limitation of purpose.

Third, the corporate law adopted a positive attitude toward the market for corporate control. On the one hand, the procedural and financial requirements of corporate restructuring were substantially removed. In other words, merger and acquisition became much easier. On the other hand, new corporate law also expanded the eligible choices of defense strategy (Kanda 2006). In other words, new corporate law

favors market mechanism as the means to counterweight abusive takeover rather than administrative control in advance. project contained the following measures (*Nikkei Shinbum* 7/11/2000). Furthermore, international merger and acquisition, which was the long term taboo for Japanese corporations, was deregulated. After the legislation, foreign corporations were allowed to use shares of their Japanese subsidy companies to finance the M&A, namely the triangular merger. It became much easier for them to acquire Japanese corporations (Kanda 2006).

3.5 Conclusion

In this chapter, I address the changes in the independent variable, policy regimes of corporate legislation. I show how the historical origins and political environments influence the composition of policy field and the policy paradigms guide the corporate legislation. I also show how the perceived corporate governance problem shifted from one of social order to one of economic efficiency and how the conceived solutions shifted from reallocating power among corporate organs to market building.

The critical question for the ideational approach is: to what degree does this transition influence the substantial legal arrangements of corporate regulatory system? What is the relationship among institutional beliefs, power and efficiency? After showing the change of the independent variable, in the following chapters, I examine how the regime shift influences the rules of corporate finance, governance structures and corporate restructuring, respectively.

Ch.4 From Capital to Shareholder Value: the Transformation of Regulations for Corporate Finance

4.1 The Significance of Corporate Finance

The relationship between law and corporate finance is a core issue in contemporary scholarship on corporate governance. The literature is dominated by two approaches. The first approach suggests that how well the law protects minority shareholders is critical for the development of direct financial market. La Porta et al. (1998; 1999; 2001) find that common law countries generally have a higher degree of financial development measured by the ratio of direct finance to GDP. They argue that this discrepancy results from the different degree of minority shareholder protection rooted in legal systems; common law countries provide best legal protections for minority shareholders and creditor and thus have higher market capitalization.

The second approach emphasizes the power struggle between new comers and incumbents in national policy. Rajan and Zingales (2003) examine the historical development of global financial market and find that the demonstrated association between legal family and financial development only appeared after 1970s. They argue that the observed association between financial development and legal system actually results from the power balance between incumbent organizations and latecomers. Because a more efficient financial market will bring more competitions that hurt the interests of incumbent firms and financial institutions, these incumbents have incentive to block financial development through political mobilization. Whether a country can overcome the vested interests have significant impacts on its financial development.

The ideational approach provides an alternative account of this issue. Both approaches are built on the assumption that equity finance conflicts with managers or incumbent firms interests by nature. Therefore, the repression over equity finance result from incumbent actors intentional or unintentional attempts to protect their vested interests. This study suggests that the incumbent actors' interests do not necessarily conflict with the development of equity finance; when their statuses are not challenged, they can also benefit from vigorous corporate finance. What truly repressed equity finance was the policy paradigm that treats it as the source of turbulence. In the Japanese case, although it is Ministry of Finance that regulates the financial sector, many parts of the regulations are prescribed in corporate law. Therefore, the dynamics of corporate legislation significantly influence the regulations for corporate finance. This chapter examines the development of three important issues of corporate finance: share repurchase, stock option and minimal capital. The regulations for these issues have experienced drastic changes in the last three decades and thus afford a strategic site for theory testing.

4.2 Japanese Corporate Finance: an Overview

At first glance, the Japanese financial system seems to confirm the mainstream argument that the repression over corporate finance results from the vested interests of controlling managers and incumbent corporations. Japanese economic system was characterized by the repression of equity finance, marginalization of shareholders and the strong power of incumbent corporations. The postwar Japanese corporate finance

was characterized by a heavily regulated, credit based, price-administrative system (Zysman, 1983). The purpose of financial policy is to ensure that corporations can obtain enough funding to invest (Caldral, 1993; Vogel, 1997). However, although Japanese corporations benefited from the postwar credit based system, unlike what the literature suggests, the community of corporate managers in incumbent firms actively promoted the deregulation of corporate finance after the 1960s. Vigorous equity finance can bring controlling managers in Japanese large corporations more financial resources and thus they did not hesitate to move to equity finance once they have the opportunity (Hoshi and Kashryap, 2001). If the Japanese business community did not support the strict regulations for corporate finance, what factors are responsible for it?

This project suggests that corporate finance is not self evident in the legislative process; thus the regulations for it cannot be separated from how it is perceived in the policy field. In the jurist paradigm, the core principle guiding the regulations for corporate finance is the principle of sufficient capital (*shihonjujitsu gensoku 資本充実原則*). Because a corporation is seen as an association composed of stable shareholders, shareholders interests are interpreted as the sustainability of the corporation. The term capital has a specific meaning in the context of corporate law; it refers to the book value of a corporation and needs to be clearly written in the corporate constitution. A corporation is required to constantly hold assets amount to the book capital in the corporate constitution. Its purpose is to ensure the sustainability of a corporation and reduce the risk of shareholders and creditors (Suzuki and Takeuchi, 1991). Also because

corporate governance was seen as an issue related to social order, law scholars and MOJ bureaucrats were highly cautious about equity finance that inevitably brings turbulence was seen as a potential threat.

On the other hand, shareholder value is the guiding principle of regulations for corporate finance in neoliberal paradigm. Shareholder value refers to shareholders total return from their investment, including dividends and the gain from the stock market (Rapport, 1986 Cox 2003). Because a corporation is seen as a nexus of contracts repeatedly negotiated in the financial markets, therefore, shareholders interest is interpreted as the returns from the corporate contracts. Therefore, vigorous equity finance, which is treated as a potential source of turbulence under the jurist paradigm, is seen as a positive way to raise shareholders financial returns became positive for corporate legislation.

This contrast between paradigms does not suggest that shareholders' return is totally ignored under the jurist paradigm or the sustainability is totally ignored under the neoliberal paradigm. What I want to emphasize here is the matter of degree and the priority of goals. In what follows I examine the development of the regulations for three issues of corporate finance: share repurchase, stock option and minimal capital.

4.3 The Evolution of the Regulations for Share Repurchase

4.3.1 Share Repurchase under the Jurist Regime

Share repurchase, which refers to the buying back of issued shares by corporate funding, is a typical strategy of raising shareholder value in textbooks of corporate

finance in the U.S. Between 1995 and 1999, American corporations spent 750 billion dollars to buy back their shares. In 1998, American investors received more cash from share repurchase than dividends (Grullon and Ikenberry, 2003). However, in Japan it is among one of the most controversial issues in legal history. Not only business groups have lobbied for the deregulation for several decades, scholars of commercial law also published hundreds of articles discussing its legal status and optimal regulations (Iwahara, 1993). The major function of share repurchase is buttressing stock price by reducing the shares circulating in the market. Before 1993, share repurchase was generally prohibited but was allowed under specific three conditions: 1. to grant shares to employees, 2. to cancel shares, and 3 at the shareholders request. The corporate law required all proposals of share repurchase had to be approved by the general meeting of shareholders and the financing scheme was limited to dividends. Corporations were also forbidden from holding the bought-back shares. These rules sufficiently blocked the share repurchase in Japan (Kitazawa, 1999; Sugita, 2006).

Japanese corporations have lobbied for deregulating share repurchase throughout the postwar period. Although share repurchase had been forbidden since the founding of Japanese corporate law, many corporations violated the regulation of share repurchase to defend against hostile takeovers and maintain stock price. In the 1950 a wave of hostile takeovers caused many corporations to secretly buy back their shares to defend their control (*Jurisuto*, 1958). However, because share repurchase was illegal, these actions were often sued by shareholders. The most famous case was Mitsubishi

Mineral, which was caught of buying back their shares through subsidiary companies in 1972 (*Nikkei Shunbum*/1980/07/02). Mitsubishi finally lost the lawsuit in 1993. In the 60s the liberalization of capital inflow further exposed Japanese big corporations to the risk of foreign acquisition, which led *Keidanren* to lobby for deregulating corporate repurchase.

Table 5: Comparison of the Regulations for Share Repurchase

Paradigm	Jurist Paradigm	Neoliberal Paradigm
Interpretation of the issue	Share repurchase may facilitate speculation and insider transaction, thus hurts the small shareholders and creditors	Share repurchase is a positive measure that enhance shareholder value
Legislation	1.Share repurchase was generally prohibited 2. Corporations can exercise it only under the exceptional conditions; 3. the procedure and financing were highly constrained.	1. Share repurchase was legalized as a normal financial strategy 2.The procedures and financing were substantially deregulated.

The 1974 Diet resolution of overhauling corporate law gave Japanese business community a chance to change the regulation. When MOJ looked for proposal of legislation, the *Keidanren* actively promoted the deregulation of share repurchase. They suggested that share repurchase could improve the financial quality of corporations and make it easier to grant shares to employees. In 1978, *Keidanren* surveyed the attitudes of big corporations and suggested that corporations from all industries supported the deregulation (*Keidanren*, 1978). In response, MOJ held several hearings to discuss the

advantages and disadvantages of share repurchase. But in their proposal for corporate legislation in 1980, MOJ still rejected the deregulation. Why did Legislative Council and MOJ bureaucrats reject share repurchase?

As I noted earlier, the sustainability of the corporation was the primary concern in the jurist regime. The first reason for their rejection was the potential hollowing out of capital. For some, share repurchase simply posed a logical contradiction. In 1925 the Osaka District Court ruled share repurchase to be illegal because it was a logical contradiction for a corporation to rescind its own components (Sugita, 2006). Even though very few scholars later held this view, many were still worried that share repurchase violated the principle of sufficient capital. The crucial factor influencing the jurist regime's attitude toward corporate finance is the legal concept of capital. Because the book value of the capital of a corporation was supposed to be recorded in the corporate constitution and could not easily be changed, share repurchase could become a shortcut to reduce the book value without passing through the required process. In other words, the sustainability of the corporation could be threatened (Motoki and Inaba, 1977).

The second reason to reject share repurchase was economic order. Even if MOJ bureaucrats and law scholars were not worried about the potential hallowing out, they were still concerned about its potential negative impact on the economic order. Three potential problems were used to justify the rejection to share repurchase. First, if corporations were allowed to spend corporate assets to rescind their shares, other

shareholders and creditors could face unequal treatment. The net assets of the corporation could shrink after repurchase, and other shareholders may suffer from loss. Creditors also faced higher risks for their lending. Second, share repurchase gives controlling shareholders and managers a powerful tool to manipulate stock prices and conduct insider trading. Controlling shareholders and managers could exercise share repurchase to increase the value of their shares compared to the price of the individual shareholders. Third, share repurchase could ossify the corporate control. Controlling shareholders and managers can easily appropriate share repurchase to resist to challenges. This could lead to the ossification of corporate power (Hoshikawa, 1977; Tatsuta, 1974; Yamamoto, 2006).

Because share repurchase could not be justified in the dominant paradigm, it was vetoed by MOJ. Despite *Keidanren*'s lobby, when MOJ and Legislative Council formed the project for corporate legislation in 1981, they totally excluded the deregulation of share repurchase in the amendment (*Jurisuto*, 1981). In their response to *Keidanren*, MOJ emphasized the potential frauds brought by share repurchase and insisted the rejection (*Keidanren*, 1978). Throughout the 80s, share repurchase was entirely blocked from the legislative process.

4.3.2 Modest Deregulation in 1994

In the early '90s the Japanese business community launched another wave of lobbying for share repurchase to solve the problem left by the bubble economy. During the period of the bubble economy, Japanese corporations heavily moved toward equity finance and

aggressively played financial engineering. In 1982, the capitalization of the Tokyo stock market was around 100 trillion yen. In 1989, it rapidly expanded to 630 trillion yen. This bubble burst in 1990 and the total capitalization of Tokyo stock market dropped to one fourth of the highest point in 1989 (Hoshi and Kashyap, 2001). The bursting of the bubble brought two immediate problems for Japanese large corporations. First, the falling stock prices led to the dry liquidity. Many corporations found themselves in a difficult financial situation and the financial turnover became extremely difficult. Second, the low stock price made many corporations vulnerable to hostile takeover. Therefore, Japanese large corporations and financial institutions faced urgent needs to pump stock prices.

To solve this urgent problem, the business groups looked to leading LDP politicians to deregulate share repurchase. *Keidanren* drafted a proposal that claimed share repurchase would bring merits: (1). to provide a better scheme for employees to hold shares, (2). to adopt stock option, (3) to serve as a defense strategy against hostile takeover, (4). to catch up the advance corporate finance in Europe and America, (5). to adjust the stock market, and 6. to return revenue to shareholders (*Nikkei Shinbum*, 04/03/1992). The second largest business organization, *Keizai Dōyukai* (Japan Association of Corporate Executives) also backed Keidanren's proposal. *Nikkei Sinbum* performed a survey that found that all major big corporations in its sample supported the deregulation (*Nikkei Shinbum*, 04/17/1992). Mori Yoshirō, The director of LDP Policy Research Council, and Kamei Shizuka, the chair of subcommittee of economic affairs,

strongly supported the deregulation (*Nikkei Shinbum* 04/22/1992). In 1992, the LDP established a special legislative team chaired by Oda Seichi to develop proposal for share repurchase.

In addition to politicians' pressure, MITI also actively promoted the deregulation of share repurchase and linked it with its broader economy policy. MITI's notion of "industrial finance" (*sangyō kinyū* 産業金融) had significantly changed since the late 1980s. In the past the policy of industrial finance focused on providing stable, long term funding for firms (Vogel, 1997). Since the late 1980s industrial finance had become an important part of corporate strategies. Therefore, share repurchase was increasingly perceived as one type of normal financial strategy. In 1992, the Industrial Bureau in MITI invited representatives of business groups and law scholar to organize Research Council for Corporate Institution (*Kigyohosekenkyukai*) [企業法制研究会], a consultant organ for the director (*Nikkei Shinbum* 04/08/1992). In 1993 the Industrial Bureau published the report supporting the deregulation of share repurchase. It argued that through share repurchase corporations could return the extra cash and assets to the hands of shareholders. It also allows corporations to develop a more flexible financial strategy, which can strengthen the competitiveness. Thus share repurchase should be seen as a way to increase, not to damage shareholders interests (Tsusanshō, 1993).

MITI's new orientation toward corporate finance was promoted by the young generation of officers who had the experience studying in the U.S.. Nakahara Toshihiko described their involvement:.[16]

"The old generation does not trust market and shows no interest in this kind of issues (corporate law). On the other hand, the young generation was very dissatisfied with MOJ's attitude toward these new tools of corporate finance. They stick to some old fashion legal theory and have no clear sense about the economy. Therefore, we tried organize the research group to express the opinions oppressed by the MOJ."

Despite pressure from politicians and MITI, the gate keepers who rejected share repurchase in the late 1970s, namely MOJ bureaucrats and the Legislative Council, did not change their minds. To buffer the political pressure from the LDP, MOJ announced that they would prolong their deliberations and postpone the bills at the first midterm report (*Nikkei Shinbum*, 01/29/1993). Raising stock prices, which had relatively little relation with the actual operation, was still saw as an illegitimate purpose for many committee members. The plummet of stock prices partly resulted from the excessive equity finance during the bubble economy; many committee members believed that the government should not bail out these careless corporations (Kurasawa, 1993; Kitazawa 1999).

The Legislative Council and MOJ convinced Ota Seichi of the potential problems of share repurchase. Despite his being on good terms with business groups and the

[16] Interview with Nakahara Toshihiko, 2006/07/12

pressure from LDP leadership, Ota was also worried that the business groups' request was merely a reaction to a short-term crisis and could bring bigger problems in the future (*Nikkei Shinbum* 1993/02/14). He rejected the deregulation of share repurchase simply for coping with plummeting stock prices and urged a cautious attitude regarding its long term effect. Through negotiation with politicians, MOJ finally agreed to minimal deregulation and submitted the bill to the Diet in 1994. In this bill share repurchase was still prohibited in general but two more exceptional conditions were added: to reduce holding revenue and to grant shares to employees. Corporations were allowed to hold no more than 3 percent of the total shares. The resolution of share repurchase had to pass through a general meeting of shareholders and the finance was limited in revenue reserve. The 1994 amendment still ruled out the notion of share repurchase as a purely financial strategy. The limited deregulation disappointed Japanese business community. The restrictive constraints on the procedures and purposes of share repurchase significantly restrained the adoption by corporations. Many corporations hesitated to publicize any plan of share repurchase in general shareholding meeting.[17] Till 1997, only 32 public traded corporations, which was less than one percent of the corporations listed in Tokyo stock market, exercised share repurchase (*Jurisuto*, 1997).

The final compromise in the 1994 amendment confirms the influence of the policy paradigm. Despite the strong political pressure, the difficulty in justifying the purpose in the dominant jurist paradigm and the uncertainty of outcome prevented lawmakers

[17] House of Representative, March 17, 1998, Committee of Juridical Affair

from fully supporting the deregulation. Because share repurchase was still interpreted as an abnormal measure, its exercise must be strictly constrained. However, as the new paradigm was gradually institutionalized in the policy field in the second half of 1990s, the regulations for corporate finance also significantly changed.

4.3.3 Share Repurchase under the Neo-liberal Regime

The regulations for share repurchase had very different direction after 1997. The end of the jurist regime removed the major obstacles to deregulation. Furthermore, a newly emerging paradigm gave share repurchase a positive meaning. Because the strict regulations for share repurchase were interpreted as part of the over-regulation that led to the stagnant of Japanese economy, deregulation became the measure that could restore it. Furthermore, some scholars began to defend share repurchase through a newly introduced financial theory. They suggested that instead of letting corporations hold excessive cash, share repurchase could release more resources to the market and enhance the flexibility of the whole economic system. They argued that the traditional notion of capital, which is the major principle for regulations for corporate finance, could not deal with the contemporary global economy (Kanda, 1992; 1995; Kobayashi, 1993). This idea was also backed by economists participating structural reform. Many economists also argued that overlooking shareholder value was one source of Japanese economic problem. Share repurchase that can return cash to shareholders was interpreted as a way to enhance shareholder value (Nakatani, 1994). After 1995, the deregulation of share repurchase constantly appeared in government economic project.

Through the endorsement of economists and reform minded entrepreneurs, share repurchase became part of the structural reform.

The new idea that share repurchase could serve as a legitimate financial strategy that enhances shareholder value had a profound impact on later legislation. It helped business groups to justify share repurchase and convinced politicians of the desirable outcome. In 1997, the Asian financial crisis caused another crash of the Japanese stock market. Many Japanese corporations faced immediate crisis. Due to the prevalent cross shareholding, the plummeting stock prices resulted in serious losses for many large corporations and forced them to sell the held shares. This created the negative cycle that further exacerbated the crashing stock market. In January 1998, the chair of *Keidanren* held an emergent meeting with Minister of Finance, Miyazaki Kiichi and requested further deregulation for share repurchase (Nikkei Shinbum, 01/14/1998). Keidanren requested two specific legislations: shifting the decision on share repurchase from the general meeting of shareholders to the board of directors, and allowing corporations to use capital reserve to buy back shares. LDP agreed with this proposal and demanded that MOJ draft a bill.

Despite the obvious practical needs similar with those before, the debate in the Diet showed a drastically different tone.[18] Ota Seiichi, the leading politician, significantly changed his position and argued that the principle of capital had already been abolished in the United States and there was no need to maintain the rules of capital reserve. They

[18] House of Representative, 1998, Mar 17, Committee of Juridical Affair

also argued that Japanese corporations had issued too many shares and accumulated too much capital reserve and it was thus appropriate to reduce shares and capital reserve at the same time. Releasing the capital reserve could improve the liquidity of the Japanese capital market and revitalize the economy.

On the other hand, not all relevant actors in corporate legislation shared the view that share repurchase should be treated as a positive measure that could raise shareholders value. Many law scholars and MOJ bureaucrats who believed in the jurist paradigm opposed this argument. In the Diet hearing, Ueda Tatsuo, a law scholar in Waseda University, expressed the concern shared by many law scholars. He suggested that Japanese corporations already had the lowest ratio self-capital ratio among major industrialized countries. Deregulation would further exacerbate this financial structure and created more irresponsible management. Furthermore, because capital reserve is highly related to shareholders and creditors interests, the appropriation should have been acknowledged by shareholders. MOJ Chief Secretary Kikuike Yoichi also showed strong concern on the appropriation of capital reserve to buy back shares. Corporate law prescribes a clear procedure for reducing the book value capital of a corporation and the amendment may become a shortcut to it. In other words, if corporations are allowed to use capital reserve to buy back shares, the principle of capital is violated hollowing out of capital is inevitable. Because this proposal was opposed by MOJ and Legislative Council, LDP Diet members decided to by pass MOJ and drafted the special law by Oda Seiichi, Yasuoka Okiharu and Ueda Isamu. The special law allowed corporations to use

capital reserves to buy back shares and the decision only needs to pass through the board of directors. This law would expire in two years.

The regime shift after 1997 radically changed the dynamics of the regulation for share repurchase. As the old paradigm lost its authority and the new paradigm was gradually institutionalized, the deregulation of share repurchase gained a positive image as a means of reviving the economy. In 1994 Ota Seicihi chose to agree with the Legislative Council's concerns and only pursued a limited deregulation; in 1998 the new paradigm justified share repurchase despite the similar motivation of business. The radical deregulation in 1998 truly gave the green light to share repurchase. Through the end of 1998, more than 1400 public-traded companies bought back their shares by capital reserves. *Keidanren* was very satisfied with this deregulation (Nishikawa, 2001). In March 2000 the special law passed in 1998 came due. MOJ began to work on a new proposal for share repurchase. *Keidanren* lobbied to retain the rules prescribed in the 1998 special law. However, concerning potential managerial self-dealing, the Legislative Council insisted that share repurchase should be authorized by the general meeeting of shareholders. The 2001 legislation returned to the 1994 regulation that required the resolution for share repurchase to pass the general meeeting of shareholders. Again, *Keidanren* looked to LDP politicians for deregulation. In March 2002 Ota Seicihci, Yasuoka Okiharu, and three other lawmakers formed a legislative team to draft the amendment. In October 2002 they formally discussed their proposal with *Keidanren* and

proreform scholar Kanda Hideki. In July 2003 the bill was passed and share repurchase was formally legalized in Japanese corporate law (Nikkei Shinbum, 07/16/2003).

Share repurchase was formally recognized as a normal financial strategy after the institutionalization of the neoliberal paradigm. The 2003 legislation, which was part of the plan "Modernizing Corporate Law", radically deregulated constraints in every dimension. First, the rule of the purposes of repurchase was abolished. Despite the continuous deregulation, share repurchase still required legitimate purposes before 2003. The amendments in 1994 and 1998 simply expanded the list of exceptional conditions; in other words, share repurchase was still treated as an abnormal measure entailing special conditions. The amendment in 2003 was the first legislation that treated share repurchase as a normal financial strategy. Second, the regulation over preservation was abolished. Before 2003 corporations were not allowed to withhold the bought-back shares for more than six months. The 2003 amendment abolished this constraint and allowed corporations to withhold bought-back shares. Third, the regulation about the maximum amount of repurchase was also abolished. The 1998 special law allowed corporations to buy back at most 10 percent of total shares. The new law in 2003 abolished this restraint, and corporations were free to buy back any amount of shares once they passed the resolution. Fourth, maintaining the 1998 rules, corporations were allowed to use capital reserves to buy back shares once they obtained the endorsement from the general meeeting of shareholders. Finally, although share repurchase still required a resolution from the general meeeting of shareholders, following the 1998

rules a general meeeting of shareholders can authorize the board of directors to determine the repurchase plan (Sugida, 2006).

The legislation in the 2000s finally shifted the legal status of share repurchase from an abnormal, emergent action to a routine financial strategy. From the historical point of view, what Japanese large corporations wanted in the last seven decades did not change much. No matter in 1950s or in 1990s, Japanese large corporations needed share repurchase to support share price and avoid hostile takeover; however, their constant political influence could not deliver the policy they favored. Not until the institutionalization of the new paradigm they had the chance to change the rules. The complicated historical development of regulation for share repurchase showed the limits of business groups' power and the influence of policy paradigm.

4.4 The Evolution of the Regulations for Stock Options

Stock option refers to financial instruments that convey the right, but not the obligation, to engage in a future transaction on some underlying security, or in a futures contract. It is often appraised as one of the most important financial product that encourage technological innovation. As I mention in the previous chapter, the deregulation of stock options in 1997 was the focal point where the regime shift of corporate legislation occurred. Its meaning experienced a radical change after Japan faced unprecedented economic crisis. The stock option, which provides the link between managerial compensation and share price, is widely perceived as an important financial innovation that promotes shareholders primary corporate governance. The stock option

was invented in 1980 and soon became a dominant compensation scheme among American corporations. Because Japanese corporate governance was characterized by

Table 6: Comparison of the Regulations for Stock Option

Paradigm	Jurist Paradigm (1974-1997)	Neoliberal Paradigm (1997-2006)
Interpretation of the issue	Stock option may create turbulence and speculation	Stock option can encourage innovation and link managers compensation with shareholders interest
Legislation	1. Corporate law prescribed pre-emptive right that could only be passively exercised and could not be transacted. 2. Warrant bond is deregulated. However, warrant is defined as preemptive right	1. Stock option formally replaced pre-emptive rights. 2.the exercise of stock option was legalized as a normal financial strategy 3. options were acknowledged as a form of asset.

the marginalization of shareholders and managerial dominance, the deregulation of the stock option in 1997 was widely praised as an important move toward shareholder primary system (Katz 1998; Vogel 2006; Jackson 2003). Although the stock option is a new financial innovation, there have already been rights related to the issuance of new shares in the future. Since 1949 Japanese corporate laws have prescribed the preemptive right (*Shinbabuhikiukeken* 新株引受権*)*, which refers to the right to subscribe to new shares when corporations issue them. This right was introduced by GHQ in 1949 as the complementary rule of authorized capital. The original purpose of the preemptive right was to protect existing shareholders when corporations issue new shares. Because the issuance of new shares inevitably dilutes shareholders interests, the old corporate law

gave existing shareholders the right to buy new shares before they were released in the market to protect their interests

After 2004 this right was replaced by the call option (*Shinkabuyoyakuken*, 新株予約権). The call option refers to the arrangement that the buyer of the option has the right, but not the obligation, to buy an agreed-on quantity of shares from the seller of the option at a certain time for a certain price. The seller is obligated to sell the shares if the buyer exercised his options. Despite their similarity, the latter has a clearer implication of a market for future shares (Kariya 2002). I discuss below this transition from the preemptive right to the call option.

4.4.1 The Stock Option in the Jurist Regime: the Deregulation of Warrant Bond

The first step in moving toward an option market was the deregulation of the warrant bond (*Shinkabuhikitsukeken tsukeshasai*, 新株引受権付社債). A warrant bond refers to the type of corporate bond that entitles the bond holder to buy stock from the company that issued it at a specified price in the future. Warrant bonds can be divided into two types— separate and nonseparate—by whether the warrant can be separately transacted from the bond. The warrant bond is an important financial innovation that can turn creditors into shareholders. Issuers can attract more capital than with ordinary corporate bonds, which only provide interest. The deregulation of the warrant bond was part of the Ministry of Finance's project of financial liberalization. The warrant bond was not on the list of corporate regulatory reform in MOJ's 1977 proposal. MOJ officers were concerned about the potential abuse of this new financial product. However, under the

support of Suzuki Takeo, MOJ, and the Legislative Council agreed to review the proposal and let it enter the legislative process. Why did the MOJ and Legislative Council, who were hostile to the complicated scheme of corporate finance, support the deregulation of the warrant bond?

Two reasons led to the MOJ's support for the warrant bond. First, unlike share repurchase, the warrant bond has a legitimate purpose beyond financial operations. The business community claimed that warrant bonds issued overseas could help them hedge against the risk of a fluctuating exchange rate (Tatsuta 1978). Second, the Ministry of Finance was also uncomfortable about the potential option market implied by the separate bond, which was opposed by MOJ and the Legislative Council. Therefore, MOF undertook the role of restraining the option market. Through informal channels, MOJ asked security firms to not issue any separate-type corporate bonds in Japan. In 1983 the Association of Japanese Security Industries agreed to "self-restrain" (*Jishuku* 自粛) in the sale of domestic separate bonds. The statistics on the issuance of warrant bonds after deregulation showed its effect. From 1981 to 1986, Japanese corporations issued thirty-two warrant bonds worth 246 billion yen in Japan, and 414 bonds worth 3808.5 billion yen overseas. All bonds issued in the overseas market were of the separate –type, and all issued in Japan were nonseparate. Five years after deregulation, no separate-type corporate bonds were issued in Japan (Takenaka 1987).

Despite their acceptance of warrant bonds, MOJ imposed restrictive constraints on the amount and procedures of issuance to prevent warrant bonds from endangering the

sustainability of the issuers and the economic order. During the deliberations, the major issue was whether the issuance of warrant bonds, which would be transformed to shares, would dilute shareholders interests (ōtori 1981). Although he did support the warrant bond, Suzuki was deeply worried that it could become the tool of financial speculation. To avoid potential speculation, MOJ established two rules restraining the issuance of warrant bonds. First, the total value of warrants issued could not exceed the amount of debenture. Because the amount of debenture could not exceed the book value capital, this regulation prevented the dilution of shareholders interests. Second, to protect the existing shareholders, the issuance of separate warrant bonds had to obtain the supermajority in the general meeeting of shareholders. Third, the warrant attached to a corporate bond was still defined as a preemptive right (*Shinkauhikiukeken*) to buy shares when corporations decided to issue new shares. Due to the heavy constraints imposed by MOJ and the self-restraint led by MOF, the option market implied by the nonseparate warrant bond was absent in Japan. Business groups were pleased with the deregulation but were still unsatisfied by these restrictive rules (Hōmushō, 1981).

4.4.2 Deregulation of Stock Options in 1997

After 1990 the implications of the option have experienced a radical shift resulting from the rise of MITI's new policy paradigm of corporate legislation. Before 1990 option was a tool to protect existing shareholders, and debate centered on restraining potential speculation and turbulence. After 1990 the meaning of option shifted to a means of encouraging innovation, and debate centered on stimulating economic growth. The

issue of stock options first appeared in MITI's economic plan in 1993. The rise of the U.S. IT sector convinced MITI officers of the importance of venture capital, which often uses stock options as a compensation scheme to attract talented employees. In 1993 MITI drafted a special law to allow venture companies to adopt stock options as a compensation scheme (Nikkei Shinbum, 02/07/1993). Through its close ties with political leadership, MITI's support for stock options was incorporated in the project of structural reform and repeatedly appeared in a variety of economic plans. The 1996 cabinet resolution prescribed the deregulation of stock options as part of the economic strategy (Naikakufu 1996). It suggested that the stock option provides an important tool for reforming rigid management and the labor market. Backed by MITI and LDP leadership, the bill also followed the traditional route through MOJ and Legislative Council.

Despite strong political pressure, the Legislative Council hesitated to pass the bill for two reasons. The first is the way that options would be issued, as proposed by MITI. The bill prescribed two ways to grant options to employees. The first path was granting preemptive rights to employees. Because it was simply the extension to the preemptive rights that already existed in corporate law, it faced no objections from the Legislative Council. However, the second way, granting shares through share repurchase, triggered strong objections. The 1994 deregulation of share repurchase only allowed corporations to buy back 3 percent of the total circulating shares. The 1996 proposal suggested expanding the maximum amount of repurchase to 10 percent. Furthermore, the proposal also allowed corporations to retain shares for ten years. Some members of the

Legislative Council suspected that the true motive of this bill was not stock options but a convenient way to repurchase share. Because the business community's attempt to repurchase shares was seriously compromised in 1994, the second path of issuing options could substantially ease the regulations on repurchase (Egashira, 1998).

The second concern was economic order. Some scholars were worried that corporations could abuse the stock option to manipulate stock prices. As I mention earlier, the jurist paradigm holds a hostile attitude toward corporate finance; they have deep concerns regarding the potential turbulence and abuse of these schemes. The experience of the bubble economy further strengthened this concern. They believed that the failure to control the issuance of warrant bonds in the 1980s was partly responsible for the bubble economy. Stock options could harm shareholder protection and exacerbate insider transactions (Morimoto 1997; Uemura, 2002). Additionally, if the stock option was deregulated, many laws had to be spontaneously changed. Many law scholars believed that until all the related laws and rules were clarified and sufficiently discussed, this bill should not be passed. The chair of the Legislative Council, Egashira Kenjirō, expressed their concern[19]:

"Basically we did not oppose stock option. However, we didn't agree the way proposed by them (Business Group). Their proposal left too many loopholes."

The Legislative Council's slow deliberation and indefinite attitude toward stock options irritated the lawmakers. In 1997 politicians bypassed the Legislative Council and

[19] Interview with Egashira Kenjirō, 7/12/2006.

passed the deregulation of stock options. As mentioned in the previous chapter, the conflict surrounding deregulation of stock options marked the regime shift of Japanese corporate legislation. The bypass of the Legislative Council was backed by LDP leadership and MITI. Although the business community had been unsatisfied with MOJ's conservative regulations for a long time, it was the discourse of structural reform that helped justify their challenge. In his statement about the legislation, Yasuoka addressed the decreasing competitiveness of Japanese corporations and stressed the urgency of stock options. He attacked the careful deliberation of the Legislative Council as inefficient and an obstacle to economic recovery (Yasuoka, 1997). As the Japanese economy faced the crisis brought by the Asian financial crisis, this argument won unanimous support from all parties, including long-term critic of Japanese business groups Sasaki Hidenori. Sasaki had long been a Diet member in the Socialist Party and an activist for juridical reform. He served as vice minister of justice in the Hosokawa cabinet, and became the leading voice in juridical affairs in opposition parties. In 1997 he was also convinced of the need for structural reform and voted for the amendment.[20]

4.4.3 Replacing the Preemptive Right of Call Option

Not until the institutionalization of the neoliberal paradigm after 2000 was the stock option truly recognized as a legitimate financial instrument that could be circulated in the market. Unlike the jurist paradigm that treated an independent option market as a source of turbulence, the neoliberal paradigm viewed it as a way to raise shareholder

[20] House of Representative, Committee of Justice, 1997/02/15

value. This difference is rooted in their fundamental assumptions regarding the nature of a corporation. When a corporation is seen as an association composed of stable members, an option market implies the uncertainty of these members' interests in the future. On the other hand, when a corporation is seen as a nexus of contracts constantly negotiated in the financial market, an option market can diversify the contracts and enhance the liquidity that can raise shareholders returns in the market. As the dominant policy paradigm shifted, the option market gained a new, positive meaning.

After the restructuring of the policy field in 2000, the option was not only deregulated but also treated as a strategy to enhance corporate value. This change was mostly accomplished by METI officers exchanging to MOJ. Through their efforts the establishment of an option market was incorporated in the plan "Modernizing Corporate Law." The amendments related to it can be summarized by the following three dimensions. First, legal terminology shifted from preemptive right (*Shinkabuhikiukeken)* to call option (*Shinkabuyoyakuken)* (Kariya, 2002). This change had profound impact on the issuance of options. The preemptive right can only be affiliated with corporate bonds or granted to specific people such as employees. Options can be independently granted to any person and can be transacted in the market. The positive attitude toward options is also reflected in the ease of procedural requirements. In the 1997 legislation, stock options still needed to be authorized by the general meeeting of shareholders. The 2001 amendment allowed the general meeeting of shareholders to delegate this power to the board of directors. In other words, the board of directors

gained the power to determine the expiration date, amount, issuance, price, and cancellation of corporate bonds. The rules of warrant bonds were also substantially deregulated. The decision to issue separate-type warrant bonds also shifted to the board of directors. The regulation that value of the warrant cannot exceed the value of the bond was also abolished. Third, the option was formally recognized as a type of corporate asset. The new corporate law adopted the Black-Sholes Model to calculate the value of options. In other words, not only was the issuance of stock option was deregulated, the demand side was also expanded (Kanda, 2006). Through these efforts the call option was formally institutionalized in Japan as a normal financial tool.

4.5 Requirement for Minimal capital

4.5.1 Minimal capital under the Jurist regime

During the 1980s one focus of corporate legislation was the requirement of minimum capital. This issue was deeply rooted in the principles of capital prescribed by the jurist paradigm. Because a corporation is supposed to maintain a certain amount of capital to protect creditors, a new corporation cannot be established without the basic amount of capital. The original threshold was set up in 1937 as ten thousand yen. This threshold lost significance after the long-term economic growth and inflation in postwar period. Incorporation in Japan faced almost no threshold of minimal capital. A direct result was the great number of small- and medium-sized enterprises owned by families (Kitazawa, 1999).

Table 7: Comparison of the Requirement for Minimal Capital

Paradigm	Jurist Paradigm (1974-1997)	Neoliberal Paradigm (1997-2006)
Interpretation of the issue	New corporations need to prepare certain amount of capital to protect creditors. Small corporations may abuse limited liability and create disorder	Creditors and shareholders should evaluate the risks by themselves. Requirement of minimal capital hurts innovation
Legislation	Incorporation requires ten million yen capital. In 1996, one sixth of corporations were forced to dissolve.	Requirement of minimal capital was formally abolished

From the view of the jurist paradigm, the absence of a requirement of minimal capital brought a significant threat to the economic order. Because the corporate law protects shareholders by limiting liability, MOJ officers and the Legislative Council were deeply worried that this protection could be abused by small family-owned corporations. To protect potential creditors, they preferred to require new corporations to own at least a certain amount of capital that could ensure minimal protection for creditors.[21] The 1974 Diet resolution gave them the chance to amend the law. Although the requirement of minimal capital had nothing to do with the corporate scandals that triggered the reform in the first place, MOJ bureaucrats exploited this opportunity to implement their vision of corporate law and put minimal capital in the seven major issues of corporate legislation declared by MOJ in 1977.

[21] House of representative, 08/01/1984, Committee of Justice.

Despite the eagerness of the MOJ and law scholars, the requirement of minimal capital faced strong political resistance. Many small and medium enterprises were important constituencies in LDP's local political machine; the requirement of minimal capital inevitably challenged their interests. Although other issues achieved certain progress in the 1980 proposal, minimal capital was the only issue without any progress except for corporate restructuring (*Nikkei Shinbum* 7/08/1985). After long preparation, MOJ proposed raising the minimal capital to twenty million yen in 1988. This proposal triggered immediate fierce opposition from small and medium enterprises, politicians from both major parties, and MITI.[22] In 1989 the book values of 90 percent of Japanese corporations were lower than this threshold. Minister of International trade and Industry, Muto Kabun, publicly opposed this legislation (*Yomiuri* 3/25/1990). Kozawa Katsusuke, a Socialist Diet member, also strongly opposed this legislation. Due to the strong opposition, MOJ lowered the threshold to ten million yen and gave existing small corporations five years to fulfill the requirement. However, even though the threshold was lowered it still significantly reduced the number of corporations. In 1987 84.2 percent of Japanese corporations' book value capital was lower than ten million. According to the estimates of the National Federation of Small Business Associations, 75 percent of small corporations could not fulfill this threshold. The representatives from the National Federation of Small Business Associations actively lobbied to stop the legislation. MITI was also worried that the legislation of minimal capital could hurt the

[22] HOR, 06/01/1990, Committee of Justice.

local economy. On the other hand, MOJ and the Legislative Council did not hesitate to acknowledge that the purpose was to prevent "over incorporation;" reducing the number of limited liability corporations was exactly the purpose of legislation.

Despite the strong opposition, MOJ successfully convinced LDP leadership of the necessity for new regulations. MOJ bureaucrats insisted that the lack of requirement of minimal capital would hurt the economic order. The Kaifu Toshiki cabinet reached a resolution for the legislation of minimal capital in April 1990 (*Yomiuri* 4/17/1990). Following the resolution, the House of Representatives passed this bill in June 1990. The law was implemented in April 1991 and the five-year extension for existing corporations was due in April 1996. This legislation had profound impact on small- and medium-sized enterprises. In November 1996 MOJ declared that 10 percent of the corporations, one hundred and ten thousands, were mandated to dissolve due to their failure to reach the minimal requirement of capitalization (*Yomiuri* 11/06/1996).

The requirement for minimal capital confirmed the insights of the ideational approach. The efficiency approach could not explain why a regulation that seems to reduce efficiency was passed, while the power approach could not explain why an unpopular law could be legislated. From the view of the ideational approach, when politicians are convinced of the desirable outcome of legislation—in this case maintaining economic order, they may choose to support it to avoid possible backlash—in this case the abuse of limited liability.

4.5.2 Minimal capital under the Neoliberal Regime

The requirement of minimal capital arguably experienced the most dramatic shift within its first fifteen years. Right after the legislation of minimal capital, new discourse about the role of small firms emerged as the economy continued to be stagnant. While in the jurist regime, small family-owned corporations were potential abusers of limited liability, the new discourse treated them as the agents of innovation and flexibility. Similar to the development of stock options, the booming IT sectors in the United States convinced many economic bureaucrats of the importance of venture capital. Throughout the '90s, the lack of venture capital was constantly treated as a source of Japan's economic problems; the requirement for minimal capital thus became an obstacle to economic recovery. In MITI's report on economic strategy in 1995, 1996, and 1998, encouraging venture capital was treated as the central step for reviving the Japanese economy (Tsusanshō, 1996; 1996; 1998). In the proposal publicized in 2001, the requirement of minimal capital became the target for reform.

The restructuring of the policy field gave METI a chance to implement their plan for abolishing the requirement of minimal capital. Following the model of stock options, in 2002 METI drafted the Law of Supporting Small and Medium Enterprises (*Chushokigyo chosenshienho 中小企業挑戦支援法*) that allowed incorporation without facing the constraint of minimal capital. These newly established companies were required to enrich their capital to the threshold of ten million yen. This law started a boom of new companies. By April 2004 fourteen thousand new companies were incorporated based on this special law. The successful experience convinced MOJ of the positive impact of

abolishing minimal capital. In December 2004 MOJ proposed permanently abolishing the requirement of minimal capital and the requirement for the newly incorporated firms to enrich capital. Under the new regime, METI and MOJ officers argued that minimal capital actually does very little to protect creditors; furthermore, the legal system should let creditors and investors evaluate the risk by themselves. This argument won unanimous support from all major parties and the bill was passed in June 2005 (Nikkei Shinbum, 06/20/2005). According to METI, the special law successfully created twenty-five thousand new companies, of which eighteen thousand had successfully enriched their capital to ten million yen. This law was widely appraised as an important step for embracing start-up companies, which are traditionally disfavored by policy.

Despite METI's dominance in corporate legislation, law scholars who believed in the jurist paradigm still upheld preserving the rules of minimal capital. Egashira, the chair of the Legislative Council, demonstrated three advantages to maintaining these rules: first, minimal capital can provide a clear rule for the imbursement of capital during incorporation; second, it can help to regulate the payment of dividends; and finally, it can help distribute the residual assets as liquidation (*Jurisuto* 2004; Uemura 2005; Inaba 2006). However, this bill bypassed the Legislative Council and was submitted directly to the Diet. It was passed in 2004.

The dramatic transformation of the requirement of minimal capital within two decades exemplified the impact of policy paradigms. The political power of small and medium enterprises did not significantly change in these two decades; therefore political

power cannot explain this dramatic change. Although it was unpopular from the very beginning, once the dominant paradigm prescribed a desirable outcome it could overcome the opposition. On the other hand, until the new paradigm provided another set of meanings that could justify its abolishment, the requirement of minimal capital could not be abolished.

4.6 Conclusion

The transformation of the Japanese regulations for corporate finance provides an important case for hypotheses testing. On the one hand, business groups seemed to win what they wanted in the last decade. As I mentioned at the beginning of this chapter, because the corporate managers can control more resources through deregulating corporate finance, they have incentive to promote deregulation. At first glance the result seemed to confirm the argument of the power approach; corporate legislation reflects the power struggle among social groups (Tiberghien 2006, 2007). On the other hand, the deregulation also seemed to confirm the efficiency approach. The radical deregulation largely occurred after Japan faced unprecedented economic crisis in the 1990s. Market-oriented legislation served as the tool to stimulate economic growth (Katz 2001).

However, when we carefully examine the long-term institutional development, these two approaches are at best problematic. First, large Japanese corporations have been part of the political establishment and have had great political influence throughout the postwar period. Even though their major political ally, LDP, lost power for two years, it soon regained control over Japanese politics that continues today. Given the limited

change of the power structure in Japanese politics, the political influence of business can be seen as constant in the postwar period. In other words, if the power approach is right, large Japanese corporations should have faced no difficulties in legalizing share repurchase in the 1960s, stopping the legislation of minimal capital in 1991, and legalizing options in 1980. However, empirical evidence suggests that although business had substantial influence, their dominant role in the political structure could not be translated into corporate legislation. The three-decades-long struggle for share repurchase and the failed resistance to minimal capital in 1991 shows the limited impact of business groups in the political process.

On the other hand, the efficiency approach may be correct in that economic efficiency became an important concern in the last decade. However, it cannot explain why economic efficiency was not a primary concern for corporate legislation previously. If economic efficiency is the self-evident purpose as the efficiency approach suggests, this concern should dominate the legislation at different times. Considering the fact that many reforms in the last decade simply undid the previous wave of reform, the explanatory power of the efficiency approach is questionable. The most striking example is the deregulation of minimal capital. If lawmakers are simply looking for the maximum welfare of the whole economic system, how is it possible to pass two contradictory laws within a ten-year period?

Furthermore, unlike the predictions of the efficiency approach and the power approach, incumbent actors, in this case managers who controlled large corporations, do

support the deregulation of corporate finance. What changes are the dominant perceptions of corporate finance in the policy field. I suggest that the ideational approach can best explain the transformation of regulations over corporate finance. As Kanda (1995) indicates, the traditional paradigm of corporate law held a hostile attitude toward equity finance and thus often hindered its development. Financial operation was treated as a potential threat to economic order and could only be allowed with appropriate purposes. The notion of sufficient capital (*Shihinjujitsugensoku* 資本充実原則) that prioritizes the protection of creditors and existing shareholders is the major principle that structures legislation. The cautious if not hostile attitude toward share repurchase, stock options, and corporate bonds resulted the deep concerns for stability and order and the perception that a corporation is an entity composed of stable shareholders. The requirement of minimal capital, which resulted in the dissolution of thousands of small corporations, was the last effort to maintain the economic order.

On the other hand, in the neoliberal regime corporate finance is the center of corporate governance. Because the central concept is shareholder value defined as stock price, financial schemes that can raise stock prices become justifiable practices. This new belief justifies and enables the deregulation of share repurchase and stock options and led to the abolishment of minimal capital. As Inaba (2006) was keenly aware, the new corporate law significantly downplayed the principle of capital and equality among shares, two golden principles that guided corporate legislation in the past. This is

consistent with the worldview prescribed by the neoliberal regime of corporate legislation.

The legislative processes of corporate finance show the impact of policy paradigm on lawmakers' judgments on legitimacy and policy outcome. Without a doubt, lawmakers, who have the ultimate power to legislate, have to respond to interest groups. However, they also have to consider legitimacy and policy outcome. When MOJ officers and law scholars in the Legislative Council dominated the corporate legislation before the mid-1990s, even politicians on good term with business groups such as Oda Seiichi supported the requirement for minimal capital in 1991 and the limited deregulation in 1994, which were opposed by business groups. On the other hand, the new beliefs not only justified LDP politicians challenge to the Legislative Council but also convinced Diet members from all parties (except the communist party) of the need for stock options and the abolishment of minimal capital. The ideational approach can better account for the legislation of corporate finance.

Ch.5 From Internal Democracy to Market Transparency: the Transformation of Regulations for Governance Structure

5.1 Introduction

Although governance structure is the focus of corporate law, both interest-based approaches say very little about it. However, experts on Japanese corporate law widely agree that the regulations for governance structure (*kaishakikan* 会社機関) experienced the most drastic transformation after 1997. As Kanda (2006) indicates, before the mid-1990s the regulations for governance structure were kept being tightened; between 1974 and 1993 the Japanese Diet amended corporate law several times to strengthen the power of auditors, individual shareholders, the general meeting of shareholders, and the board of directors to control managers. After the mid-1990s, these rules were deregulated and controlling managers won stronger flexibility in the operation of governance structure. What caused this transformation?

Both the efficiency approach and the power approach fail to provide satisfactory explanations to it. The efficiency approach suggests that the deregulation after the mid-1990s simply resulted from the irresistible market force. However, it cannot explain the tightening of regulations before the mid-1990s. It also cannot explain why corporations adopting new governance structure performed worse than those that didn't. For the power approach, the changing legislative course reflected the shift of political preference or power structure. Nevertheless, the preference of the Japanese corporate community for governance structure remained stable and their political power received few

challenges. The Japanese business community has been an essential part in the political establishment of the LDP regime throughout the postwar period. Even during the tumultuous political realignment in the '90s, business groups never lost their political leverage. The preference of Japanese business groups also remained stable. Japanese corporations were largely controlled by managers in the postwar period (Hoshi and Kashyap 2003; Nokocchi 1994; Miyajima 1985). The later developments of lifetime employment and bank-based finance further strengthened managerial dominance and the marginalization of shareholders. These controlling managers favored the expansion of executive power and resisted the involvement of "outsiders" in corporate governance, including small shareholders and independent directors. Because the board of directors was and still is largely controlled by managers, the Japanese business community favored expanding its power, enhancing the flexibility, and resisting the attempt to break its closed composition. If the power structure and large corporations' preferences remained unchanged, what drove this transformation of the regulations for governance structure?

The crux of the arguments of this chapter is that shareholders' interest, which is the first principle of governance structure, is not self-evident but is socially constructed; different paradigms prescribe different understandings about the natures of shareholders interest and the resulting measures. Therefore, even by the same name of shareholders' interest, the legislation went different directions under different paradigms. In 1996 an MOJ officer （*Jurisuto* 1996） noted that although business

journalism generally accused the Japanese economic system of ignoring shareholders, legally speaking Japanese shareholders have more rights than their U.S. counterparts. Many decisions that need to pass the general meeting of shareholders in Japan only need to pass the board of directors in most states in the United States. His comment reflects the deep differences in the very definition of shareholders' interest in two paradigms. In the jurist paradigm, the relationship between a corporation and its shareholders is similar to that between a nation and its citizens. Under this paradigm, a corporation is seen as an association collectively owned and controlled by shareholders. Just as citizens cannot directly govern the country, it is also impossible for shareholders of large corporations to actually operate the corporation by themselves. Therefore, as in a democratic regime, shareholders interest is protected by establishing the system of checks and balances within corporations. The solution to the corporate governance problem is strengthening the power of the corporate organs for checks and balances, namely auditors and the general meeting of shareholders. The general meeting of shareholders is the organ that exercises the "sovereignty" of shareholders (Suzuki 1981). Shareholders are assumed to approve important plans, oversee appointment of officers and directors, and hear the annual report from the executive branch, and so on.

On the other hand, under the neoliberal paradigm market transparency is the central issue for shareholder protection. Because a corporation is seen as a nexus of contracts constantly negotiated in financial markets, shareholders' interest implies fair terms in the financial market. Information disclosure to market, board independence,

and a compensation scheme of executive pay can thus better serve shareholders protection. This paradigm dominated the understandings of shareholder interests in contemporary social science. In literature the degree of shareholder protection is generally measured by four indicators: information disclosure, board independence, voting process, and the degree to which executive pay is connected with share price (Gourevitch 2007). All indicators except for the voting process are related to market transparency; none of the indicators has anything to do with the "rights" owned by shareholders or the general meeting of shareholders. In what follows I discuss the transformation of regulations for governance structure.

5.2 Historical Background: the 1949 Amendment and its Impact

When the Japanese model of corporate governance is considered, the discussion overwhelmingly concentrates on the contrast between the stakeholder-oriented system in Japan and the shareholder primary systems in Anglo Saxon countries. Students of the Japanese corporate system have widely noticed that large Japanese corporations are more a community of employees (especially managers) than the property of shareholders（Dore 2000; Nakayama and Sreeck 2001, 2003; Itami 2001; Iwai 2006; Niwa and Netarai 2006）. Although this characterization reflects the actual operation of Japanese corporations, Japanese corporate law has never deviated from the principle of shareholder ownership since the very beginning. In other words, the debate around employee sovereignty (*juyoin shuken* 従業員主権) does not permeate to the field of

corporate legislation. The divergence in corporate legislation results from the different perception of the relationship between a corporation and its shareholders.

In the history of Japanese corporate law, the 1949 amendments instructed by GHQ had significantly changed the governance structures. In prewar corporate law, the general meeting of shareholders served as the organ of decision making and directors served as the representatives of shareholders. The 1949 amendment established the board of directors and its relationship with the general meeting of shareholders. It also removed the power of monitoring executions (*Gyōmu kansaken* 業務監査権) from auditors to the board of directors. Although in GHQ's original design the board of directors served the function of monitoring executive directors, the board of directors soon became part of the executive branch; thus no internal organ took charge of monitoring. Additionally, although auditors were endowed with the power of inspecting accounting, the lack of requirements for qualification also prohibited the function of the accounting auditor (Kojima 2001). The 1949 amendment also endowed individual shareholders with new rights to counteract the executive branch. These new rights introduced by GHQ, including the right of derivative action (*kabunushi daihyo sosho* 株主代表訴訟), the right to inspect corporate accounts (*chobo etsuranken* 帳簿閲覧権), and the right to propose the dismissal of directors（*torishimariyaku kainenken* 取締役解任権）, provide legal tools for protecting shareholders. The 1949 amendment also established a high threshold to avoid the abuse of these rights. The second theme of corporate legislation was refining the rules related to these rights (Nakahigashi, 1999).

As I mentioned previously, the corporate scandals that erupted since the late 1960s triggered the first wave of corporate legislative reform. The idea of shareholder democracy played a critical role in the responses of MOJ and law scholars to corporate misconduct. The lack of monitoring is attributed to the insufficient exercise of shareholders sovereignty and inadequate allocation of rights among corporate organs. The Diet resolution to thoroughly overhaul corporate law gave MOJ bureaucrats and law scholars in the Legislative Council the chance to implement their vision of corporate law.

5.3 Regulations for Governance Structure under the Jurist Regime

5.3.1 Regulations for General meeting of shareholders

Table 8: Comparison of the Regulations for General meeting of shareholders

	Jurist Paradigm (1974-1997)	Neoliberal Paradigm (1997-2006)
Interpretation of the issue	General meeting of shareholders is the place where shareholders exercise their "sovereignty" of the corporation. Strengthening the power of general meeting of shareholders is an important way to avoid managerial misconducts	General meeting of shareholders is the place where shareholders confirm their delegation of power of directors.
Legislation	Legalize the right of question Legalize the right of raising proposal Legalize the right to dismiss directors, Legalize absentee votes :galize the right to determine directors mpensation Require important financial decisions, :luding share repurchase and the issuance corporate bond to pass general meeting of areholders	Shift the power of important financial decisions to board of directors.

The first issue for the jurist regime was to vitalize the general shareholders meeting that is designed to be the highest organ for exercising shareholder sovereignty. Although shareholders are assumed to be the "owners" of a corporation, most shareholders do not really participate, and the general meeting of shareholders was controlled by the executive branch. Japanese scholars and media often used the term *Keigaika* (形骸化), which means losing all substantial functions, to describe the real conditions of the general meeting of shareholders. Japanese corporations were notorious for holding general meeting of shareholders on the same day, and the meetings generally lasted less than a half hour. Furthermore, in Japan the general meeting of shareholders became the arena where the mafia blackmailed managers. The term *Sokaiya* (総会屋) refers to the mafia who threaten to publicize scandals unless they receive money, or disturbing the general meeting of shareholders. *Sokaiya* is a widespread practice among large Japanese corporations (Tatsuta 1981).

The critical factor influencing the legislation was how these problems were interpreted under the dominant policy paradigm. In the jurist paradigm, managerial misconducts were interpreted as the result of insufficient empowerment of the shareholders, the solution was considered to be strengthening the power of the general meeting of shareholders (Otori et al. 1981). Using the 1974 Diet resolution for thoroughly overhauling corporate law, MOJ announced its proposal in 1980 and the bill was passed in 1981. These amendments contained the following elements. First, the old corporate law did not allow shareholders to raise proposals other than for the appointment of

directors. The amendment endowed the shareholders with the right to make proposals and established the threshold of the proposal to 1 percent of the total shares or three hundred shares (*kabunushi teianken* 株主提案権). Second, the old corporate law did not clearly prescribe the shareholder's right to ask questions at general meeting of shareholders (*shitsumonken* 質問権). The amendment unambiguously prescribed shareholders right to ask questions and the directors and auditors obligation to answer. Third, the amendment required corporations with fixed capital of more than five hundred million to submit documents related to the proposal raised by the executive branch. This was seen an important step of information disclosure to shareholders. Fourth, the old corporate law required shareholders to attend the general meeting of shareholders to vote on important decisions. The amendment legalized absentee votes that allowed shareholders to vote without attending the general meeting of shareholders （欠席投票）. Fifth, regarding the problem of *Sokaiya,* the old corporate law only punished those who received bribes. The amendment clearly put the responsibility on the corporation's side and forbade paying corporate assets to specific shareholders（利益供与） (Inaba, Motoki, and Hamasaki 1981).

Before 1997 MOJ constantly allocated the power of important decisions to the general meeting of shareholders when deregulating other corporate behaviors. The deregulations of warrant bonds in 1981, share repurchase in 1993, and stock options in 1997 required resolution in the general meeting of shareholders. However, the 1981 amendments were the last wave of large-scale adjustments to the legal rules of the

general meeting of shareholders. The only amendment related to the general meeting of shareholders after this time was the legalization of the digital shareholders meeting and votes that received unanimous support in 2003. Strengthening the general meeting of shareholders had almost no substantial impact on Japanese corporate governance for two reasons. First, these newly established rights posed no substantial challenge to the business community who were supported by cross-shareholding. As I mentioned earlier, because Japanese big corporations were controlled by the management teams who own extremely small portion of the total shares, these controlling managers developed complicated cross-shareholding to protect their control. Once their control was protected, small shareholders can hardly challenge them. The only impact was the moderate extension of the duration of the meeting due to establishing the right to ask questions. Many corporate directors or officers had to face difficult questions from shareholders. However, cross-shareholding prevented any meaningful challenge to corporate control and thus corporations reluctantly accepted this reform (*Jurisuto*, 1986).

Second, most small shareholders simply showed no interest or ability to participate in general meeting of shareholders even after the empowerment. Ochiai （1996） examined the general meeting of shareholders between 1995 and 1996 in Japanese publicly traded corporations and found that among more than 1600 public traded corporations, only thirteen received proposals submitted by ordinary shareholders; 86.7 percent faced no questions at all from shareholders in the general meeting of shareholders. Although Japanese corporations were and still are notorious for ignoring

shareholders, this survey shows that shareholders were also reluctant to exercise their rights in the general meeting of shareholders prescribed by corporate law. In other words, the original attempt to curb managerial misconduct through the general meeting of shareholders virtually failed.

5.3.2 Board of Directors under the Jurist Regime

The board of directors was formally introduced in 1949 and vaguely endowed with the power of executive affairs. In the original design of GHQ, the board of directors represented shareholders in operating the corporations. In reality, it became part of promotions and was mainly composed of managers. Because the size of the board kept expanding in postwar Japan, the internal hierarchy within the board emerged and the senior members controlled the decision making. Many large corporations delegated the important decision to the informal committees of regular directors (常務会) in the board, and junior directors had little substantial power in decision making. As a result, even the board of directors faced the danger of losing its function (形骸化) (Takano, 1981).

For MOJ bureaucrats and law scholars in the Legislative Council, the loose regulations for the board of directors were also responsible for the corporate scandals. Under the dominance of Motoki Shin, the chief secretary of Civil Bureau and Suzuki Takeo, strengthening the regulation for board of directors was listed in the seven priority issues of corporate legislation publicized in 1976 (Hōmushō, 1976; Kurasawa, 1981). Because the board of directors' rights and duties were unclear, directors could easily escape responsibility. They thus proposed strengthening the regulations over the

board of directors. First, the 1981 amendment posted two new duties for directors: restriction on covenants and restraints on indirect transactions. Directors were forbidden from using their positions to hurt the corporations. Second, it also expanded the responsibilities of directors. Third, it shifted the power of four types of important decisions from individual directors to the board. These important decisions included: the disposal of important property, large amounts of loans, the hiring and firing of important contractors, and the establishment, change, and abolishment of important organizations. To strengthen the independence of auditors the power of appointing and dismissing accountant auditors was removed from the board of directors and given to the general meeting of shareholders.

Fourth, the old corporate law allowed the board to establish rules that determined the specific director who could call a board meeting. In practice, most corporations delegated this power to the CEO (社長). To maintain the function of the board of directors, the 1981 amendment clearly defined the right of all directors to call a meeting. Finally, the 1981 amendment clearly prohibited directors who had specific interests to vote in resolutions. MOJ further attempted to differentiate the functions of decision making and monitoring within the board. In the proposal submitted in 1980, MOJ proposed establishing a committee of operation that clarified the responsibility of decision making. This bill provoked strong opposition from the business community and was withdrawn in the legislative process (Motoki, 1981). In short, the legislative purpose of the rules related to the board of directors was to save the board of directors

from becoming the rubber stamp of a small number of senior managers. By mandating board resolutions in a variety of issues, MOJ aimed to make board of directors more accountable. However, the assumption behind these reforms on board of directors was that board of auditors should take charge of monitoring and board of directors takes charge of decision making. This assumption significantly deviated from GHQ's original design for board of directors.

5.1.3 Board of Auditors under the Jurist Regime

Under the jurist regime, the second solution to curb managerial misconducts is strengthening the power of auditors. As I mention earlier, the amendment dominated by GHQ in 1949 left two loopholes for monitoring. First, the board of directors, which was designed to monitor the executive branch, became part of the executive branch. Second, although auditors retained the power to inspect corporate accounts, there were no requirements regarding the qualifications of auditors. Therefore auditors had no ability to examine the corporate accounts. For many Japanese law scholars, the removal of power from auditors in 1949 was the direct cause of the lack of monitoring over managers; the solution was thus to strengthen the power of auditors (Suzuki 1981; Nakahigashi, 1999). The Sanyo Steel scandal that erupted in 1965 further convinced MOJ and the Legislative Council of this need. Four proposals about strengthening monitoring had been submitted to the Legislative Council since 1966. The first proposal suggested maintaining the limitation of auditor's power in accounting auditing. The second one suggested retrieving the power of monitoring executive affairs to board of auditors. The

third proposal was adopting the German model that gives auditors the power to appoint and dismiss directors. The fourth proposal was adopting the American model that abolishes board of directors and shifting the whole power of monitoring to board of directors (Suzuki, 1968; Kitazawa, 1999).

Table 9: Comparison of the Monitoring Mechanisms

	Jurist Paradigm (1974-1997)	Neoliberal Paradigm (1997-2006)
Interpretation of the issue	Managerial misconducts can be prevented by internal check and balance among different organs. The removal of power from auditors in 1949 was responsible for the corporate scandals	The only effective way to monitor directors is market mechanism. The focus of governance structure should be
Legislation	1. Retrieve auditor's power of monitoring executive affairs. 2. Require big corporations to establish board of auditors and appoint regular auditors. 3.Legalize auditor's right of calling directors meeting and the right of hearing director report. 4. Extend the term of auditor to four years and require corporations to appoint independent auditors	1. METI proposed to abolish board of auditors and mandate independent directors. Facing strong resistance from business groups, METI compromised and allow corporations to choose between one tier board with independent directors and two tier boards. 2. Require large corporation to establish internal control system within the executive branch and shift part of auditors function to it.

Legislative Council finally determined to adopt the second proposal which returned to the rules before 1949. Taking the chance of continuing the corporate scandals that had erupted since the late 1960s, MOJ proposed two amendments. First, it reinstated the auditors' power to monitor executive affairs （業務監査権）. Second, it required

corporations with capitalization more than 500 million yen to appoint licensed accountant auditors （*kaikeikansanin* 会計監査人）to inspect the financial reports. These two amendments received unanimous support, and the Diet reached a resolution to thoroughly amend the corporate law. Legislative Council and MOJ captured this opportunity and further strengthened auditor's legal power.

Because enhancing internal checks and balances was perceived as the solution to managerial conduct, the bill drafted by MOJ clearly assigned the power and duty to the board of auditors. First, corporations with capitalization of more than 500 million yen were required to appoint more than two auditors; one of them had to be a regular auditor (*Chokin kansayaku* 常勤監査役). Second, auditors were endowed with the power to hear reports from key employees if they felt it was necessary (*Hokoku seikyouken* 報告請求権). Third, auditors were endowed with the right to call meetings of the board of directors (取締役会招集権). Fourth, in the old corporate law the compensation of auditors was bound to that of the directors. In other words, they had economic incentive to cover for the directors. To strengthen the independence of auditors, the new corporate law separated the procedures determining their compensation. Fifth, regarding the fees needed for the auditors, the burden of proof shifted from auditors to directors. In the old corporate law auditors were required to prove that they used the money on relevant affairs. The new corporate law stated that unless directors

could prove that auditors did not use the money on auditing, they could not refuse to pay it (Kitazawa, 1999a).

The new wave of corporate scandals caused by the burst of the bubble economy triggered public concern for the long-lived problem of Japanese corporate governance. The rules of auditors were further strengthened in 1993, when the United States and Japan reached the "Structural Agreement" to reshape the Japanese corporate system. Responding to the Structural Agreement, MOJ proposed three amendments in 1993: lowering the threshold for derivative shareholder lawsuits, lowering the threshold for inspecting corporate accounts, and strengthening the board of auditors. Interestingly, although the amendments relating to the auditors were joined with those relating to derivative actions and the right to inspect corporate accounts, they were not part of the Structural Agreement. In other words, MOJ exploited this opportunity to implement their agenda for auditors. MOJ proposed the following legislation. First, to ensure the independence of auditors, the term of auditors was extended to three years. Second, large corporations were required to appoint at least one independent auditor who had not worked in the given corporation or its related firms. Third, a board of auditors was established. These amendments were passed in 1993 (Yoshikai, 1996; Kitazawa, 1999b).

Despite MOJ's effort, Japanese corporations were still reluctant to appoint true outsiders into the board of auditors. A 1998 survey conducted by the Japanese Association of Auditors revealed the reality of independent auditors (Suzuki 1998). The average number of auditors in large Japanese corporations was 3.8. The average number of independent auditors was 2.2. However, most of the independent auditors were actually insiders in the corporation. A total of 42.7 percent of the nonregular independent auditors were directors or managers from related corporations; 9 percent were previous employees of the given corporations or related corporations.

MOJ spent twenty years from 1974 to 1993 to undo the removal of auditors' power that had been prescribed in the 1949 amendment. The underlying assumption is that managerial dominance should be curbed by the checks and balances within a corporation. However, despite the continuous effort, it is widely agreed that auditors hardly had any substantial functions in Japanese corporate governance (Miyamoto, 2003; Kintō, 2003). Because auditors were generally promoted from the management team, they were often part of the management team. Therefore almost no auditor ever exercised his right to control directors amid the new wave of corporate scandals (Ueda, 2006). On the other hand, the Japanese corporate community often supported strengthening the power of auditor to avoid the implementation of independent directors that

was popular in the United States. In 1997 as a series of financial institutions went bankrupt, *Keidanren* proposed further strengthening the institution of auditors. This strategy was also widely used after 1997. However, the paradigm shift brought new dynamics to this issue.

5.4 New Paradigm, New Focus: the Regulations for Governance Structure under the Neoliberal Regime

The neoliberal paradigm has a very different understanding of the nature of a corporation and shareholders interest. Because a corporation is seen as a nexus of contracts for the neoliberal paradigm, market transparency that can ensure the fair term in the contracts is the conceived solution. Thus regulations concentrated on board independence and information disclosure to the market. Similar to what occurred in the mid-1960s, a series of scandals of false financial reports and irresponsible management erupted in the 1990s after the bubble burst. Despite the similarity of these events, the neoliberal regime adopted very different measures to curb managerial misconduct: independent directors (社外取締役) and an internal control system (内部統制). The restrictive rules that were imposed under the jurist regime were considered unnecessary and even as an obstacle to economic flexibility. Under the neoliberal regime they thus tended to be deregulated. In what follows I introduce the major legislations under the jurist regime.

5.4.1 The Clash over Independent Directors

The term "independent director" refers to a member of the board of directors of a corporation who is neither an employee of the company nor affiliated with it in any way. Appointing independent directors is the norm among United States public traded corporations. However, it was taboo in Japanese corporations, in which most directors were promoted internally. In Japan the issue of independent directors first emerged in 1975 when the Diet passed resolutions to thoroughly review corporate law (Ueda, 1999). However, due to strong opposition from the business community and the reluctance of MOJ, this proposal soon disappeared in the arena of Japanese corporate legislation and did not reappear until the mid-1990s. In the 1990s as the Japanese economy fell into recession and the U.S. economy became more prosperous, the U.S. model of corporate governance received more attention among Japanese scholars, bureaucrats, and policymakers. Leading scholars and entrepreneurs serving in a variety of government committees, including Nakatani Iwao, Miyauchi Yoshihiko, and Takenaka Hezo, actively promoted the U.S. model of corporate governance as a remedy for Japanese economic problems. Miyauchi (2000) denounced the function of auditors and lifetime employment and argued that the only solution to Japanese economic problems was to adopt the flexible management of the U.S. model. His voice was strengthened by the rising influence of pro-reform entrepreneurs and scholars in Japanese politics. The most influential advocate of this view, Miyauchi, joined a variety of government committees in the mid-'90s to propose his reform project. In 2001 he was appointed as chair of the Committee for Regulatory Reform *(Kisei kaikaku kaigi*), a consulting committee for the

prime minister. Although he had no direct authority over corporate legislation, his proposal for structural reform nonetheless became appealing to a country facing a desperate economic situation.

The new president of SONY, Idei Nobuyuki, also actively promoted the reform of corporate governance. Based on the general practice of American corporations, SONY changed the structure of its board of directors since 1997. First, in 1997 it introduced the institution of executive directors (*Shiko Yakuin* 執行役員) who take charge of executive operation. Second, it introduced the internal division of labor within the board of directors by establishing the Committee of Compensation (報酬委員会) and the Committee of Appointment in 1998. Third, in 2000 it separated the chair of the board of directors from the top executive director within the board. Sony's reform received widespread appraisal from the business media and foreign investors and provided the blueprint for the later reform. Fourth, in 1999 Sony appointed Nakatani Iwao, the advocate of Japanese economic reform, as the independent director (Tōyō Keizai 1999).

These views and practices paved the way for the rules of mandatory independent directors. Although traditionally MITI was well known for its hostile attitude toward foreign capital, after the mid-1990s attracting foreign investment became its most important policy goal (Theme, Aug/2001). Because the Japanese model of corporate governance was seen as the source of Japanese economic problems, introducing foreign capital with more advanced concepts of corporate governance was seen as a solution.

The METI officer who took charge of corporate legislation, Nakahara Toshihiko, described their concern:

"Of course Japanese model of corporate governance has its merits. However, the recession in 1990s also shows its limitation. Japanese corporations not only lack innovations in high tech industries such as software, but also lack innovation in the ways of doing business. For example, Japanese computer makers just failed to create Dell-like business model. That's why we believe Japan needs to introduce foreign capital. The purpose is to bring new economic thinking."[23]

As noted earlier, METI took advantage of the opportunity of personnel exchange to send two officers to MOJ to participate in drafting the bill for corporate law. Nakahara Toshihiko, a METI officer, was sent in exchange to MOJ to undertake the task of corporate legislation. His 2003 lecture on corporate governance in RIETI (Research Institute of Economy, Trade and Industry) revealed METI's attitude toward governance structure..[24] He argued that the main purpose of the reform of the board system was to overcome informational asymmetry and transaction costs for investors. By reforming the board system, investors could find corporations with good governance at lower cost. Nakahara's lecture revealed a fundamental shifting of the perception of shareholders in corporate legislation; shareholders were no longer the stable members in an association but the investors in financial market. From this approach, breaking the closed managerial community became the primary goal for corporate legislation.

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[23] Interview with Nakahara Toshihiko

[24] http://www.rieti.go.jp/cgj/en/columns/columns_008.htm.

In March 2001 the newly restructured MOJ announced the proposal for new corporate law that radically transformed the basic organizational structures of large corporations. First, the board of auditors was abolished. Second, the new corporate law mandated that more than half of the directors on corporations' boards had to be independent. Third, three committees had to be set up: an auditing committee (*kansaiinkai* 監査委員会), an appointment committee (*shimeiinka*i 指名委員会), and a compensation committee (Hōshūiinkai 報酬委員会). The auditing committee would replace the board of directors and serve the function of monitoring. The appointment committee was in charge of the appointment of the executive officer that represented the company. The compensation committee determined the compensation scheme of the executive officer. Directors would leave operative management and limit their involvement in deciding the basic management principles of the company, as well as the framework for its internal control system. The issues requiring the vote of the board of directors were significantly reduced. The tenure of the director and the officer would be one year, and their liability would be reduced provided that they acted in good faith and without serious negligence. The board was also responsible for voting on the appropriation of profit and disposition of losses (Tobashi 2001).

Despite METI being on good terms with business groups and support from *Nippon Torishimariyaku Kyokai*" (日本取締役協会) led by Miyauchi and Idei, this legislation aroused strong opposition from large Japanese corporations. The Committee of Corporate Governance of *Keidanren* argued that the decision to appoint independent

directors should be left to each corporation. Two arguments were raised to support their opposition. First, they argued that independent directors could not take responsibility for their own decisions and could not fit into the culture of Japanese corporations. Because independent directors only temporarily serve in corporations generally composed of long-term employees, it is impossible for them to take responsibility for their decisions. Second, there is no pool of independent directors that have the necessary professional knowledge about the executive affairs of given corporations (Yomiuri 4/19/2001). The CEO of Canon, Netarai Fujio (2006), openly claimed that "the independent director can only be a decoration without any substantial help for corporate governance" (Netarai and Niwa, 2006: 35). The director of legal affair in Keidanren, Iwama Yoshihito, presented Keidanren's basic attitude toward independent directors

"We thought the appointment of independent directors is nothing but image making. The institution of independent directors simply doesn't fit Japanese corporations. We thought this kind of legislation is meaningless and cannot help Japanese economy.[25]"

As a compromise, *Keidanren* offered an alternative proposal through Diet members. This proposal focused on auditors and contained four amendments. First, large corporations were required to appoint half of the independent auditors. Second, auditors were required to attend the meetings of the board of directors. Third, if auditors resigned, they had to explain their reasons in the general meeting of shareholders.

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[25] Interview with Iwama Yoshihito, 2006

Fourth, the term of auditors was extended to four years. The strong opposition finally forced the compromise of the proposal. In 2002 MOJ publicized the final draft that allowed corporations to choose between the traditional two-tier system and the one-tier system with the obligation to appoint independent directors (Nikkei Shinbum 04/06/2002). Furthermore, the legal definition of independent directors was also loosened. This amendment was passed in May 2002.

The resistance against independent directors resulted more from the Japanese corporate culture than from a small group with vested interests. The reformers focused on accountability to the international financial market, while most Japanese managers still believed that a corporation should be viewed and operated as a community of employees. A later survey demonstrated the dominant worldview shared by ordinary Japanese white-collar workers and managers. In 2003 *Nikkei Shinbum* (Japanese Business News) held a public debate between Miyauchi and the star CEO of Cannon, Netarai Fujio, about whether Japanese corporations should adopt the U.S. style of corporate governance. Unlike Miyauchi who favored the U.S. system, Netarai was widely seen as one of the major defenders of Japanese management. The subsequent survey showed that 60 percent of the readers agreed with Netarai, while only 25 percent agreed with Miyauchi (*Nikkei* 7/01/2003). Since *Nikkei Shinbum* is the most widely distributed business newspaper in Japan, this survey accurately reflected the popular attitude shared by Japanese managers and employees.

In addition to conflicting with traditional practice, the problematic performance of corporations adopting the new system was also responsible for the limited diffusion of the new system. Until September 2005 only sixty-eight public traded corporations had adopted the new system of the company with committees. Most of these were members of the Japanese Association of Directors or large synthetic electronic corporations including Toshiba, Hitachi, and Sharp. Sony was often praised as the most "reform-minded companies" in Japan (e.g. *Tōyō Keizai* July /1999). Following the six years of reform, in 2003 SONY faced unprecedented deficits and Idei announced a new plan of reform. Exploiting the choices provided by the 2002 amendment, Idei invited several important reformers of Japanese corporate governance, including Nissan CEO Carlos Ghosn, Orix CEO Miyauchi, Oda Hiroko, and several others, to join the board and adopted the one-tier board system. Nakatani Iwo, who had served as SONY's independent director since 1998, was appointed as the chair of the board of directors. Among those adopting the new institutions, SONY was among the few that actually appointed more than half independent directors. However, the reform did not improve SONY's performance by any standard; it lost market shares of its major products to its major rivals. In terms of the negative impacts of reform, SONY is not the only case. In July 2003 when the 2002 amendment was implemented, corporations with committees had the same average market capitalization as that of other corporations. In 2005 as the Japanese economy and stock market began to rebound, these corporations significantly lagged behind the average Japanese publicly traded firms in terms of market

capitalization and ROE (*Nikkei Bijinesu* 8/2006). The poor performance forced Idei to resign in 2005. It also stopped the spread of the committee system.

5.4.2 Internal Control System

The requirement for an internal control system was another of METI's efforts to improve market transparency of Japanese corporations. This idea first came from the COSO (Committee of Sponsoring Organizations of the Tread way Commission), a U.S. private-sector initiative formed in 1985 to curb the fraudulent financial reporting that was prevalent in the early 1980s. In the report published in 1992, COSO identified three objectives of internal control: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations. It also identified five elements of internal control: (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring. After the eruption of the Enron scandals, the American public became more aware of the importance of internal control. The standard operating procedures established by COSO were adopted by the U.S. congress. The 2002 Sarbanes-Oxley Act (also known as SOX) clearly required corporations to establish an internal control system based on COSO's procedure.

METI and MOJ bureaucrats noticed the issue of internal control before its legislation in the United States, and originally planned to use it to replace the traditional auditor. The requirement for an internal control system first appeared in the 2001 proposal for board reform, before the legislation of the Sarbanes-Oxley Act (Koriya 2001). This

proposal required the Auditory Committee to establish an internal control system. Because the attempt to abolish the board of auditors was compromised in 2002, MOJ adopted another strategy to promote the internal control system. In the bill formed in 2005, MOJ required the board of directors of both the one-tier and two-tier type of public traded corporations to establish an internal control system. Corporations were required to submit reports on internal control every year to the authority of security transaction (Kariya 2005).

What are the differences between internal control and the traditional auditor? The tasks for the auditor are limited to compliance with the law and adequateness of managerial behavior. Efficiency, risk, and information disclosure to outsiders was never the issue in the design of the auditors system. Auditors are responsible for their citizens—shareholders. Although internal control also includes these two dimensions, it contains two different elements. First, it includes organizational performance and profitability. In other words, not only illegal but inefficient management are the targets of control. Second, the purpose of internal control is to provide the correct signal for the share price in financial markets. In other words, the internal control system is responsible for the financial markets.

This rule was unpopular with both law scholars and the business community. Although they supported the attempt to discipline managers, many law scholars were uncomfortable with the overlap between the auditor and the internal control system. For corporations with a one-tier board, the function of monitoring is naturally handled by

the auditory committee within the board of directors and thus faces no obvious problems. However, for corporations with a two-tier board, the board of directors that is supposed to be monitored by auditors was granted with the power to establish an internal control system. This creates legal ambiguity and hurts the coherency of the body of corporate law (Morimoto et al. 2007; Egashira et al. 2005). The business community did not welcome this rule as well. In a symposium the director of legal affairs at Toyota openly expressed his confusion about who should take responsibility for monitoring (Jurisuto 2006). Because Toyota uses the two-tier board system, he felt confused about the task of monitoring that overlapped between auditors and the internal control system. Most public traded corporations felt it was troublesome to establish an internal control system. According to the survey by *Teikoku Databanku* in 2007, 65 percent of corporations planning to be listed on the stock market reported that establishing an internal control system was the most difficult task; 55 percent reported that the requirement for an internal control system increased costs and viewed it as a negative factor of listing on the market (*Teikoku Databanku*, 2007). The passage of internal control regulations confirmed the insights of the institutional approach. As Tibergehien (2007) indicates, the establishment of the internal control system is part of the "golden bargain" whose end is to attract foreign institutional investors. However, the critical issue is why this "golden bargain" was accepted in the first place. This legislative process shows that it is neither a measure to cope with immediate crisis nor a request from Japanese business community.

Rather, it is part of the reform project rooted in the newly institutionalized paradigm that prioritizes market transparency as a means to protect shareholders.

5.4.3 Deregulation of the Corporate constitution

One of the most important changes of corporate law under the neoliberal regime is the expansion of choices for governance structures. Corporations can form their own organization based on resolutions in the corporate constitution. This deregulation radically changed the relationship between corporate law and corporations in Japan. Corporate law can be divided into two types according to its relationship with corporations: mandatory and enabling corporate law. Mandatory rules (*kyōko hōki* 強行法規) force private agents to follow strict rules prescribed in statutory law, while enabling rules (*nini hoki* 任意法規) provide optional statutory provisions and allow parties to reallocate their rights based on consents (Coffee 1989). A classic example of enabling rules is the phrase in the Delaware code "unless otherwise provided in the certificate of incorporation." Enabling corporate law serves the role of facilitating contracts and parties are allowed to establish their own contracts once they reach agreement.

The deregulation of the corporate constitution marked the transition of Japanese corporate law from mandatory to enabling rules. Until the 2005 amendment, Japanese corporate law was basically a mandatory statue. All of the organizational design, methods of existence, process of decision making, and contents of shareholders rights were prescribed by the commercial code. However, the 2005 amendment gave corporations substantial choices in these four areas. First, in terms of organizational

design, corporate law provided eighteen choices. The old corporate law only allowed three. Second, in the old corporate law corporations were not allowed to establish rules to constrain the transfer of shares. The 2005 amendment allowed corporations to establish a variety of rules about shareholders exit from the corporation and constrain the transfer of shares (譲渡制限). Third, in terms of decision making, the new corporate law gave corporations choices regarding the dismissal of directors, distribution of residual assets, responsibility of accountant auditors, and the threshold of derivative shareholder lawsuits. In the old corporate law, these rules were clearly prescribed in the statue and corporations had no choices at all. Fourth, the 2005 amendment prescribed nine types of shares that contain different shares. In other words, it became possible for shareholders in the same corporation to own different sets of rights and duties based on the corporate constitution. Finally, the very definition of the corporation was changed. In old corporate law, a corporation was defined as an association with specific purpose of profit seeking. The new corporate law simply removed the term "association" and only defines the purpose of the corporation (Yamamoto, 2006).

The deregulation of the corporate constitution radically undermined the legal principles of the jurist paradigm. Because of the great impact of corporations on the entire society, under the jurist regime corporate law was a mandatory, semipublic law. Loose regulation was perceived as the source of turbulence. A representative opinion from this viewpoint is Inaba Takeo's criticism of the 2005 amendment. He argued that deregulation of the corporate constitution could create many loopholes that could be

used to exploit minority shareholders (Inaba 2006). Furthermore, the deregulation of corporate constitution violated the principle of shareholders' equal treatment (*Kabunushi byōdō gensoku* 株主平等原則), which is the golden principle in old corporate law. Because the new corporate law allows a corporation to issue different types of shares that prescribe different rights and duties, its shareholders inevitably have different legal statuses. Also, the issuance of trade-retrained shares also brings discrepant rights and duties to different shareholders. To what degree shareholders are still "equal" became an important issue for many Japanese law scholars who believe in the jurist paradigm (Uemura, 2006).

Table 10: Comparison of the Regulations for Corporate Constitution

	Jurist Paradigm (1974-1997)	Neoliberal Paradigm (1997-2006)
Interpretation of the issue	All corporations should follow the same set of strict rules to avoid potential chaos.	Shareholders should have the right to form unique corporate contracts for their best interests
Legislation	1. Three choices for organizational design. 2. Not allow restrain on share transfer 3. The rules of dismissal of directors, of the distribution of residual assets, of the responsibility of accountant auditors, and the threshold of derivative shareholder lawsuits are clearly prescribed in law. 4. only allow two types of special shares	1. Eighteen choices for organizational design 2. Allow to restrain share transfer 3. Corporations are allowed to have their own rules of dismissal of directors, of the distribution of residual assets, of the responsibility of accountant auditors, and the threshold of derivative shareholder lawsuits. 4. allows nine types of special shares

On the other hand, from the approach of the neoliberal paradigm, because incorporation is not that different from contract making, there is no reason to prohibit parties from choosing from many possible forms of corporate contracts based on mutual agreements. This is the rationale of deregulating corporate constitution. The remarks made by Kanda Hiseki in the Diet hearing demonstrate this position. In his defense for deregulation, he argued that although freedom of contract cannot be applied to corporate law, the freedom of the form of the corporate constitution can be seen as its extension. In other words, the status of corporate law shifted from semipublic law to the extension of contract law.[26]

5.5 Conclusion

The legislative process of rules for governance structure provides an important source for examining competing theories. On the one hand, as the power approach suggests, business groups did show strong influence. They successfully blocked legislation of independent directors in 2002. They also earned stronger autonomy through the deregulation of the corporate constitution. As I mentioned in the beginning of this chapter, because large Japanese corporations are controlled by managers who spend their entire careers in one corporation, they favor stronger managerial autonomy and resist the involvement of outsiders in corporate governance. Thus the result seemed to confirm the argument of the power approach; corporate legislation is caused by power struggle. On the other hand, the deregulation also seemed to confirm the

[26] Committee of Judicial Affairs, 6/07/2004.

efficiency approach. The radical deregulation largely occurred after Japan faced unprecedented economic crisis in the 1990s. Market-oriented legislation served as the tool to stimulate economic growth (Katz 2001).

However, when we carefully examine the history, these two approaches are at best problematic. First, because the efficiency approach argues that reform will bring a better outcome, the very criterion to verify efficiency approach is outcome salience. We should observe better performance in reformed organizations, but as I mentioned, corporations that adopted new governance structure performed no better, and sometimes even worse, than other corporations. Third, although the power approach can explain why certain reforms were blocked, it cannot explain the formation of the legislative agenda. Throughout the process, business groups passively coped with the agenda set by other actors. Business groups could say little under the jurist regime. Even under the neoliberal regime which is widely considered as friendly to business, they still have to face unfavorable proposals, such as independent directors and internal control. Curbing the problems of managerial dominance was constantly the main purpose of legislation.

The most important problem faced by these two approaches is the change of legislative agendas. Efficiency is supposed to be a universal principle; while the power structure of Japan only experienced modest changes. Neither approach can predict substantial changes in the legislative course. However, this is not the case. Before 1993, the legislative agenda concentrated on the institutions of the general meeting of shareholders, auditors, and the board of directors. The focus of legislation lies on the

rights allocated to different corporate organs. Legislation after 1990 focused on enhancing flexibility and making corporations more responsive to financial markets. Ensuring that investors pay a fair price replaced the rights of stable shareholders as the major issue of legislation.

This result confirms the insights of ideational approach. Although the power struggles can be observed in the legislative process, the overarching legislative course is shaped by the dominant policy paradigm. Despite the strong resistance from business groups, both legislative regimes still achieved part of their agenda. The jurist regime successfully established the auditor system and strengthened the general meeting of shareholders, while the neoliberal regime implanted the internal control system into large corporations and partially introduced the independent directors. In other words, power and efficiency approaches may be able to explain the dynamics of specific piece of legislation, only the institutional approach can explain the long term development of the regulations for governance structure.

Ch.6: Breaking the Taboo: the Transformation of Regulations for Corporate Restructuring

6.1 Introduction

Corporate restructuring refers to the fundamental change of corporate entity, including merger, acquisition, divestiture, and takeover. The most important legal issue for most jurisdictions is the hostile takeover, which refers to a takeover that goes against the wishes of the target company's management and board of directors. In the U.S. context, corporate restructuring is mainly conducted through financial markets; different parties in the restructuring reach deals through buying, selling, and exchanging shares. Corporate restructuring is an important source of profit for investment banks and other financial institutions. In agency theory, corporate restructuring, especially takeover, is the core mechanism for maximizing shareholders wealth. First, corporate restructuring disciplines managers. Corporations with poor management suffer from low stock prices and are vulnerable to acquisition or merger. Through this process, poor management is replaced and overall efficiency can be raised. Even for corporations that have not been acquired, this pressure can push management teams to improve their governance (Jensen 1989). Second, corporate restructuring encourages optimal allocation of resources. Corporations can freely buy and sell different units and subsidiary companies to develop the best structures. Through this process the allocation of resources can be more efficient. Third, corporate restructuring is an important way to solve the problem of insolvent corporations. Bankrupt corporations

can reduce the financial damage to their shareholders by merging with other corporations or divestiture (Rapport 1986).

For large Japanese corporations, a flexible scheme of restructuring brings both leverage and threats. When managerial power is not threatened, the deregulation of corporate restructuring can enhance controlling managers' power in executive affairs. Controlling managers have more room to reorganize business operations (Milhaupt 2004). However, a flexible scheme of restructuring can also raise the chances of management turnover through hostile takeover. Thus Japanese corporations did not unconditionally support the deregulation of corporate restructuring; they preferred rules that could simplify friendly takeovers but prohibit hostile takeovers. Despite the business community's stable preference, the rules related to corporate restructuring were radically deregulated to the degree that hostile takeovers became possible after the late 1990s. I discuss below the evolution of rules for corporate restructuring in postwar Japan.

6.2 Corporate Restructuring under the Jurist Regime

Table 11: Comparison of the Regulations for Corporate Restructuring

	Jurist Paradigm (1974-1997)	Neoliberal Paradigm (1997-2006)
Interpretation of the issue	Corporate restructuring may hurt shareholders interest thus need to be strictly regulated.	Corporate restructuring through financial market is an important way to raise shareholder value and monitor managers
Legislation	1. Merger and acquisition required to be acknowledged by two general meeting of	1. Accompanied with the deregulation of shareholding company, share exchange, share transfer and triangular merger were deregulated.

	shareholders 2. Cash was the only allowed scheme of financing.	2. The procedure for restructuring was also simplified. 3. International triangular was deregulated. Due to the strong resistance from business groups, Japanese government agreed to postpone the implementation for one year. The deregulation was enacted in 2006. Business groups lobbied for constraining international triangular merger, but METI and LDP rejected it.

Under the jurist regime, corporate restructuring is treated as a specific event that can bring serious damage to shareholders and creditors. The old corporate law prescribed very complicated procedures for the merger, acquisition, and divestiture of corporations. Once the contracts for merger and acquisition were formed, the corporations had to first call for a general meeting of shareholders to recognize the proposed M&A. The acquiring corporation then had to inform all creditors within two weeks. If any creditor dissented, the corporation had to either repay debts, provide enough collateral, or establish trust that would ensure future repayment. Once this procedure was completed, the corporation had to call a second shareholders meeting to report the results, called the "reporting general meeting" (*Hōkoku Sōkai* 報告総会). Only after this meeting could a corporation register the M&A. In addition to the procedural requirements, the old corporate law only allowed cash as the financial scheme for restructuring. Between 1930 and the late 1990s these rules went almost unchanged (Umemoto, 2006).

Although old corporate law established restrictive rules, it by no means eliminated all opportunities for restructuring. In the 1950s a moderate movement of M&A activities emerged in Japan. Some even pursued hostile takeovers that later became taboo for the Japanese business community. The most famous case was the fight for control of Shirokiya, one of the earliest department stores in Japan. Yokoi Hideki and Hori Kyusaku, two businessmen backed by the Bank of Chiba, actively purchased the shares of Shirokiya and tried to control it between 1952 and 1955. The two camps had several fights in general meeting of shareholders; Yokoi finally sold all of his shares to another department store—Tōkyū Department Store. In addition to the hostile takeovers, many corporations were also actively involved in M&A to expand their scales (Okumura 1976).

Three factors ended this short restructuring boom. First, restructuring did not bring the expected positive results. Corporations generally launched M&A to strengthen economy of scale or scope. Many corporations found that the resulting economy of scale or scope did not compensate for the cost of restructuring (Okumura 1990). Second, the formation of the Japanese model of corporate governance since the mid-1949s further restrained the development of market for corporate control. As Japanese corporations increasingly became communities of employees, restructuring became less favorable for Japanese managers. Furthermore, the liberalization of capital inflow in the 1960s triggered the large-scale cross-shareholding among Japanese large corporations. This made it more difficult for the market for corporate control to emerge in Japan (Hoshi and Kashyap 2001). The lack of hostile takeover was widely considered as a feature of

Japanese model of capitalism (Kester, 1996). Third, during the high growth period, Japanese corporations rapidly expanded and formed complicated networks and business groups (*keiretsu*) centered at the banks. These business groups preferred to enter new business by building their own subsidiary company, and thus had little need of corporate restructuring.

In addition to the short history of the market for corporate control, in the postwar period the Japanese government, especially the MITI, played an active role in large-scale corporate restructuring. However, they preferred administrative measures to financial markets. The dominant logic of the resturcuting was not profit, but the international competitiveness of strategic industries. Because Japanese economic bureaucrats believed that Japanese corporations were too small to compete with their foreign rivals, they actively promoted the merging of firms to adjust the industrial structure. Furthermore, because Japanese bureaucrats distrusted market competition, they favored using administrative means to organize the market. The term "industrial rationalization" (*Sangyō gōrika* 産業合理化) refers to the effort to reduce the number of firms, expand the scale of production, and enhance the productivity in strategic industries (Gao 1997; Johnson 1982). The most important case was the formation of Nippon Steel Corporation in 1970. MITI bureaucrats directed the merger between two leading steelmakers, Fuji Steel and Yawata Steel, to form an industrial champion that could compete with foreign steelmakers. The government-instructed restructuring in steelmaking is widely perceived as a typical example of Japanese industrial policy (Tilton 1995).

These developments made the rules surrounding corporate restructuring in corporate law irrelevant before 1990. MOJ tried to simplify the complicated rules for restructuring when the Diet passed the resolution for overhauling corporate law in 1974. In the initial proposal by MOJ, corporate restructuring was listed as one of the seven issues for deliberation. Suzuki Takeo believed that these rules were out of date and could not deal with the rapidly changing economy. However, due to the lack of urgency, corporate restructuring did not truly enter the policy agenda until the economic crisis in the mid-1990s.

6.3 Economic Crisis and the Deregulation of the Shareholding Company

The critical issue for corporate restructuring in the 1990s was the deregulation of the shareholding company. The shareholding company was the dominant form of prewar Zaibatsu; Zaibatsu families controlled the shareholding companies that held the shares of hundreds of subsidiary companies. Through this arrangement the Zaibatsu family could easily control the whole group from a central point (Shitatani 1996). After the Second World War, the occupational authority dissolved the Zaibatsu and forbade any corporation to hold more than 5 percent of other corporations' shares. Because this rule was Article 9 in antimonopoly law, it was often called "another article nine" in comparison with Article 9 in the constitution that prohibits Japan from owning militaries. Although the pre-Zaibatsu developed *keiretsu* networks centered in commercial banks, these networks did not have a center equivalent to the prewar shareholding company (Gerlach 1992). Japanese economic bureaucrats and the business

community were strongly dissatisfied with this rule because it was widely perceived as the foundation of Japanese economic democracy; however, it was never seriously challenged before the mid-1990s.

The burst of the bubble created an urgent need to restructure large Japanese corporations. After the burst of the bubble, many Japanese corporations suffered from the overexpansion that occurred during the high growth period and the bubble economy. Almost every large business group had thousands of subsidiary firms, and many of them were not competitive in the market. Furthermore, the great number of subsidiary firms made efficient management extremely difficult, if not impossible (Itami 2005). Many corporations complained that the restriction on the shareholding company prohibited them from effectively restructuring and actively lobbied for its deregulation. In February 1995, the Research Group on Corporate Institution of MITI published a report supporting the deregulation of the shareholding company (Tsusanshō, 1995). Its argument can be summarized as follows. First, liberal democracy had already been rooted in Japan and the prewar Zaibatsu was unlikely to revive. Second, other parts of the antimonopoly law could effectively prevent the over concentration of economic power. Third, fierce global competition also made domestic monopoly unlikely. Fourth, the shareholding company allowed corporations to deploy multinational operations in a more flexible fashion. Finally, the shareholding company allowed corporations to dissolve cross-shareholding (Ida 1995). In March this issue was incorporated into the

cabinet resolution of deregulation. In 1997 the half-century-long prohibition of the shareholding company was finally abolished (Johnson 1982; Gao 1997).

Abolishing the restrictions on the shareholding company had been MITI's long-term goal since the implementation of the antimonopoly law (Johnson 1982). Why it was so easily passed at this time? On the one hand, MITI's argument had a point. In the 1990s the Japanese economy as a whole was much less likely to be controlled by a small group of business groups than in the prewar period. The economic crisis also repressed opposition. On the other hand, the movement of structural movement also gave this old issue a new meaning. In the past MITI's attempts were often interpreted as a business-government collusion, and Article 9 was interpreted as protection for free economy and treated as the cornerstone of postwar democracy (Shitatani 1996). However, in the movement of structural reform the restrictions on the shareholder company were interpreted as part of the overregulation that led to economic rigidity. The most important event was the endorsement from the Subcommittee of Deregulation on this issue. The subcommittee was mainly composed of economists who had long criticized government intervention with the economy in Japan; the restriction on the shareholder company was now interpreted as an unnecessary government intervention. Miwa Toshirō, a committee member and an economist famous for his libertarian views toward the economy, suggested that the regulation was unnecessary (Miwa 1996). Kanda (1997) also suggested that the deregulation of the shareholding company marked the increasing influence of economics in the legal field.

Through this process MITI dominated the amendment of the rules of corporate restructuring. After the report supporting the deregulation of the shareholding company was published, the Research Institute of Japan, a think tank affiliated with MITI, further organized a "Research Group for Commercial Law" (*Shōhōkenkyukai*) to deal with the details related to the deregulation. Fourteen of the twenty-one members were representatives of large corporations and only the other seven members were law scholars (Yoshida 1998). This composition was drastically different from the Legislative Council that was mainly composed of law scholars. Although the policy field of corporate legislation was not directly involved with the deregulation of the shareholding company, it was involved with the adjustment of ancillary rules. Through the Research Group, MITI established an agenda to amend the complementary rules of corporate restructuring. These issues included (a) merger, acquisition and divestitures of corporations; (b) triangular merger, and (c) share exchange. The corporate legislation related to restructuring between 1997 and 2000 largely followed these plans.

The first issue was the simplification of merger and acquisition and the establishment of the rules of divestiture. The reporting shareholder meeting was abolished and the protection of creditors was simplified. Once a corporation demonstrated its ability to repay the debt in the future, creditors were not entitled to object to the merger and acquisition as the old corporate law prescribed. The second issue was the rules of divestiture (spin-off company). The old corporate law did not prescribe rules for corporate divestiture. The proposal from MITI allowed corporations

to divide property and business to multiple subsidiary corporations. Through these two rules, business groups were able to reorganize their subsidiary companies (Abe 2000; Kanda 2006).

The second set of issues was diversifying the means of restructuring. In the old corporate law cash was the only financing scheme allowed for merger and acquisitions. In 1997 MITI proposed deregulating stock swap and triangular mergers. Stock swap refers to the procedures where acquiring corporations use their shares to pay the shareholders of the acquired corporations. The shareholders of acquired corporations receive the shares of the acquiring corporations and become the shareholders of acquiring corporations. Triangular merger refers to a more complicated scheme of restructuring. In a triangular corporation, an acquiring corporation establishes a subsidiary company to merge with the acquired company. The shareholders of the acquired corporation receive the shares of the acquiring corporation, not the subsidiary one. Through this process the acquired corporation will become the subsidiary company of the acquiring corporation. These two measures significantly enhanced the availability of restructuring (Ochiai 1998).

As discussed earlier, after 1997 the Legislative Council and MOJ lost the power of setting the agenda. Most of these bills were first proposed by MITI, not by MOJ. Nevertheless, these amendments also passed the normal procedure of corporate legislation. Members of Legislative Council did show reservations regarding the deregulation of restructuring; for example, Egashira Kenjiro, the leading scholar in

Legislative Council, noted that the apparent consensus on deregulating the shareholding company could bring some unexpected side effects in the future (Egashira1998). However, since this issue was incorporated into Hashimoto Rūtarō's project of big bang reform and Legislative Council lost their veto power in 1997, they had little leverage to counter it. .

The deregulation of the shareholding company and the completion of complementary rules created a moderate market for corporate controls in Japan. From the historical point of view, the number of M&As did significantly increase after the legislations. Before 1997, there were only 500 M&A per year in Japan. This number rose rapidly after 1997 and reached 1881 in 2002 (Matsuko 2003). Additionally, more than one hundred shareholding companies were established based on the new rules. In particular, the financial institutions that suffered most from the burst of the bubble actively exploited this deregulation to reorganize their operations. However, compared with other countries Japan still has a far smaller market for corporate control. Japan's M&A constituted only 4 percent to 6 percent of the global M&A, which is only half of the ratio of Japan's GDP to global GDP (Ochiai 2006).

Although it is doubtless that the number of M&A rose rapidly after 1997, the M&A in Japan were quite different from those in U.S. A great portion of them were restructuring within business groups. According to the statistics of Nomura Security, between 1997 and 1999 more than half of the restructurings were within group restructuring; although this ratio declined after 2000, it was still higher than 40 percent

(Matsuko, 2003). In other words, despite the vigorous M&A after the legislation, American style market for corporate control was still weak in Japan.

6.4 New Regime, New Conflict: Corporate Restructuring after 2000

The rules of corporate restructuring were largely finished between 1997 and 2000, and the legislation after 2000 can be seen as its extension. Two major issues after 2000 were defending strategies from hostile takeovers and international triangular mergers. Despite the common direction toward establishing a market for corporate control, the attitude of business groups was drastically different from the previous period. In 1997, *Keidanren* published a report urging the Japanese government to deregulate the triangular merger. In February 2007, Netarai Fujio, the president of *Keidanren*, urged the Japanese government to make more restrictions on the triangular merger (*Tōyō Keizai*, Dec/2007). What caused this difference in *Keidanren*'s attitudes toward regulations for corporate legislation?

Keidanren's changing attitude reflected the dilemma that the Japanese business community faced in the regulations for corporate restructuring. As I mentioned earlier, the deregulations of corporate restructuring brought both leverage and threat to controlling managers, contingent on whether their control was challenged. Nevertheless, a vigorous market for corporate control inevitably enhances the chance of hostile takeover. The restructuring between 1997 and 2000 largely occurred within each business group; relatively few cross-group restructuring existed except for the insolvent banking sector. However, the bursting of the bubble made large Japanese corporations

extremely vulnerable to hostile takeover. After the stock prices plummeted, Japanese corporations were forced to sell held shares to compensate. Therefore the traditional defending strategy of cross-shareholding collapsed in this process. In 1993 46 percent of total shares measured by capitalization were held by "stable shareholders," a synonym for cross-shareholding in Japan. In 2003 this ratio declined to 24 percent (Kinto 2006). As I mention earlier, after the dissolution of *Zaibatsu*, Japanese large corporations were controlled by of managers who generally owned very small portion of shares. Without cross shareholding, the chance of hostile takeovers is much higher. Some young entrepreneurs backed by foreign financial institutions actively grasped this opportunity to launch hostile takeovers toward some corporations with low stock prices and valuable corporate assets.

The most famous actor of the wave of M&A was the M&A Consulting, Inc (also known as Murakami Fund) organized by Murakami Yoshiaki who was once an officer of MITI. Murakami served in MITI between 1983 and 1999 and participated in the research committee on issues related to M&A. In 1999 he exited MITI and used the connections made in his bureaucratic career to establish the M&A Consulting, Inc. He successfully raised 3.8 billion yen and began to launch takeover bids. Because Japanese stock market was in a desperate shape in 2001, Murakami often forced the management teams in acquired companies to pay huge price to defend their control. These actions stirred strong panic among Japanese large corporations and became the symbol of the fights between new and old Japanese capitalism (Yamada and Yamada, 2006)

In addition to domestic takeovers, large Japanese corporations were also extremely vulnerable to foreign acquisition in the early 2000s. After the Asian financial crisis, foreign financial institutions had become major players in Japanese financial markets. In 1993 foreign financial institutions held only 6 percent of the total value of the Tokyo stock market; this ratio rose to 21 percent in 2002. Furthermore, the long-term recession had significantly repressed Japan's financial markets. The total market capitalization of the Tokyo stock market was only 25 percent of that of the New York stock market in 2004 (Tiberghien 2007). Except for the automobile sector, most Japanese corporations had much smaller market value than their foreign rivals. In the pharmaceutical industry, the average market value of leading U.S. corporations was seven times that of Japanese leading corporations. The retailing sector also showed a similar pattern. The discrepancy in financial markets provided strong leverage for foreign corporations to pursue takeovers in Japan.

The new policy paradigm played a decisive role in shaping the government response to the rising chance of international acquisition. This vulnerability to foreign acquisition was nothing new in Japanese economic history; the status of latecomer in industrialization and managerial control after the dissolution of Zaibatsu made Japanese corporations vulnerable to foreign acquisition. The formation of cross-shareholding in the 1960s was a direct response to the rising threat of foreign acquisition brought by the liberalization of capital inflow (Hoshi and Kashyap, 2001). However, this time the economic bureaucrats supported foreign acquisition. According to Gao (1997), Japanese

economic bureaucrats traditionally saw foreign capital as a threat to the development of domestic industrial development and actively exploited formal and informal means to prevent the entrance of foreign capital. However, the young generation of economic bureaucrats held a very different view toward foreign capital. Because they blamed the Japanese model of corporate governance for stagnant economy after 1990, they treated foreign capital as a source for bringing new dynamics to the rigid Japanese economic system. In a series of reports published by MITI (and METI after 2000), M&A began to be viewed as an active tool for transforming the Japanese economy; they planned to use restructuring to transform Japanese corporate governance and to introduce foreign corporations with better technologies or management skills (Tsusanshō 1991, 1996, 1998; Keisanshō 2002, 2006).

This new attitude toward foreign capital was further backed by the political leadership. They were convinced that introducing foreign capital is an important way to revive Japanese economy. After Koizumi Junichirō assumed Prime Minister in 2001, promoting M&A was treated as an essential part of national economic strategy. In 2003 the Cabinet established a Commission on M&A (M&A kenkyūkai; M&A 研究会) and appointed Ochiai Seichi, an important advocate of law and economics, as the chair. The report published by the commission in 2004 highly praised the positive impact of the market for corporate control and proposed a comprehensive reform on the legal institutions surrounding M&A. It argued that unless Japan adopted a "global standard" it could not compete in the global economy (Ochiai 2006). From this angle, foreign

financial capital, which was once treated as a threat to economic independence, was now seen as the solution to Japanese economic problems. Based on this report, the Japanese government actively amended its corporate regulatory system to promote the market for corporate control.

This new attitude toward foreign capital was embodied by the deregulation of the international triangular merger. This deregulation significantly strengthened the possibility of merger and acquisition. In addition to the domestic trend of hostile takeovers, METI further promoted foreign takeovers, which had long been a taboo for many Japanese corporations. The legislation between 1997 and 2000 limited the financing scheme of share exchange to those issued in Japan. In other words, only Japanese corporations were eligible for triangular mergers. However, in the project of "Modernizing Corporate Law", foreign corporations were allowed to use foreign shares to conduct triangular mergers in Japan. This amendment significantly raised the chances of foreign acquisition in Japan (Nakahigashi, 2006).

The choice of regulations for hostile takeover also reflects this new attitude toward market mechanism. Two main approaches exist for regulating hostile takeovers. In Europe (including Britain) the regulations concentrate on the rules of public tender offer that prevents unnecessary takeovers in advance. When the acquiring corporation successfully takes over, it is required to purchase all shares sold by original shareholders at a price claimed in advance. In other words, acquiring corporations must prepare enough cash before launching the takeover bid. Defending strategies are highly

restrained or even prohibited in some countries. On the other hand, in the United States the "burden of defense" lies on the shoulders of the acquired firms. Most states gave corporations great latitude for adopting a variety of defending strategies, including poison pills. The states do not impose regulations in advance and let the market mechanism determine the results of the takeover. Because the European style of regulation inevitably represses attempts of takeovers, the proposal of the Modernizing Corporate Law adopts the U.S. style of regulation that does not restrain takeovers in advance but lets corporations develop a defending strategy (Keizanshō 2006).

Furthermore, the protection for dissenting shareholders also shifted toward a market-oriented measure. Once a corporation launches or accepts a merger or acquisition, the dissenting shareholders have the right to require the corporation to buy back their shares at fair prices (*Kabushiki baishu seikyūken* 株式買取請求権). The critical issue lies in the definition of fair price. In the old corporate law, fair price is defined as repairing the net loss resulting from restructuring. However, in the new corporate law fair price includes the synergy gain in the financial market. In other words, the definition of fair price shifted to the market value of restructuring (Yamamoto 2006; Furuyama 2005).

METI's promotion of foreign acquisition and choice of regulations were criticized not only by business groups but also by law scholars. The first target of criticism was the protection for creditors and shareholders. Because the procedure of merger may be involved with disputes with creditors and shareholders, the court is the final arbitrator

when the dispute occurs. However, because the Japanese judicial system does not have jurisdiction over purely foreign firms, it cannot solve disputes in international triangular mergers. Thus the protection prescribed in corporate law may not be effective in international triangular mergers (Fujita 2007). Second, some law scholars preferred the European style of regulation that restrains hostile takeovers in advance to that of the United States that allow acquiring and acquired firms to fight against each other. They argued that the European style could bring a more stable market for corporate control (Yamamoto, 2007). However, as I emphasized earlier, as law scholars were marginalized after 1997, these suggestions did not influence the agenda set up by METI.

METI's choice of regulatory style and the emergence of hostile takeovers brought the issue of defending strategies into the spotlight. Many corporations developed a variety of defense strategies against potential hostile takeovers. These actions raised the concern that Japanese managers would use this opportunity to expand their power (*Nikkei Shinbum* 08/24/04). In 2004 METI and MOJ organized a "Research Group of Corporate Values" to establish guidelines for defending strategies. METI published the report in 2006 and insisted on the positive effect of the M&A market. It announced four principles for defense strategy: strengthening corporate values, global standard, indiscriminative to foreign capital, and expanding eligible choices (Kanda et al. 2006). This attitude is drastically different from that of the 1960s. When capital inflow raised concerns for potential foreign acquisition, bureaucrats and politicians did not hesitate to assist Japanese corporations in resisting it. However, this time METI confirmed their

preference for market mechanism and rejected requests to restrain foreign acquisition. This contrast reflects the transformation of economic ideology among Japanese economic bureaucrats (Dore 2006).

6.5 Nippon Hōsō Event and the Postponement of International Triangular Merger

The *Nippon Hōsō* event in 2005 exemplifies the hostile takeovers and defending strategies brought on by new corporate law. Horie Takabumi, the CEO of the Internet firm Livedoor, launched a bid of hostile takeover toward Fuji TV, the largest private television station in Japan. Fuji TV exemplified the typical Japanese corporation that relied on cross-shareholding to maintain control. The management team of Fuji TV was supported by cross-shareholding with *Nippon Hōsō* (Nippon broadcasting System, Inc.), a small broadcasting company. Allied with the investment bank Rehman Brothers, Horie launched a takeover bid toward *Nippon Hōsō*. If this act succeeded, Livedoor would naturally become the controlling shareholder of Fuji TV. On February 9, Horie had held 35 percent of *Nippon Hōsō*'s shares. On February 24, *Nippon Hōsō* declared it would issue the stock options of forty-seven million new shares to Fuji TV; the total circulated shares of *Nippon Hōsō* totaled only thirty-two million shares. In other words, *Nippon Hōsō* would become Fuju TV's subsidiary firm once the shares are issued. Horie did not accept this issuance and went to court to determine the legal status of the issued shares (Nikei Shinbum, 02/10/2005). On March 24 the Tokyo High Court ruled that this issuance was illegal. However, because Livedoor also exhausted the cash they could

deploy in this takeover, they finally compromised with Fuji TV and reached an agreement for cooperation (*Nikkei Sinbum* 02/12/2005).

Although Horie's attempts finally failed, this event nonetheless reminded Japanese corporate leaders of their vulnerability from hostile takeovers. The fear of foreign acquisition caused a new wave of lobbying to stop the implementation of the new corporate law (*Nikkei Sinbum* 03/08/2005). Many LDP politicians shared the concerns of business groups and questioned the deregulation of foreign acquisition (*Nikkei Shinbum* 03/12/2005). Due to the strong reactions from the business community, the LDP government agreed to postpone the implementation for one year to let corporations develop defending strategies. However, *Keidanren* was not satisfied with the postponement. In October 2006, *Keidanren* proposed raising the threshold for triangular mergers. In the 1997 amendment, triangular mergers needed to obtain approval from two-thirds of the shareholders attending the general meeeting of shareholders, and the attendants had to hold more than half of the total shares. *Keidanren* proposed raising the threshold to two-thirds of the total shareholders, which virtually prohibited triangular mergers. They argued that the deregulation of the international triangular merger could lead to the outflow of Japanese technology (Shiota 2007).

Keidanren's resistance to the international triangular merger did not merely reflect the vested interests of a small group, but the general opinions among Japanese corporations. Just before the implementation of the deregulation of triangular mergers in 2007, Teikoku Databank conducted a survey on the attitudes toward deregulation of

international triangular mergers. Among the seven thousand respondents, only 7.9 percent of the respondents reported positive expectations of the deregulation, while 46.4 percent of the respondents reported more concerns than positive expectations. These ratios were similar among large, medium and small corporations.[27] However, despite the strong opposition, METI and MOJ stood firm on their position on corporate restructuring. The vice minister of METI, Kitahata Takaaki, suggested that corporations should "develop their own defending strategies" and should not expect the government to restrain hostile takeovers. The chair of LDP's project team of corporate reform, Tanabashi Yasufumi, also rejected *Keidanren*'s request. Tanabashi was worried that *Keidanren*'s request was based merely on short-term interests and could hurt economic prospects in the long run (*Nikkei Shinbum* 04/25/2007). The deregulation of the international triangular merger was implemented in May 2007.

The rejection of tightening the regulations for international triangular mergers confirmed the impact of the policy paradigm. Japanese large corporations' resistance toward foreign capital never changed; however, new paradigm brought new legislative course. The ideational approach suggests that the key issues were whether the request could be justified and whether lawmakers were convinced of the desirable outcome. Just as elected politicians hesitated to support the deregulation of share repurchase in 1993, they also hesitated to challenge the market mechanism prescribed by the neoliberal paradigm, although both challenges were supported by business groups.

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[27] This result can be found on http://www.tdb.co.jp/english/news_reports/w0703.html.

6.6 The Impact of the New Rules for Corporate Restructuring

Although it is premature to reach conclusion about the effect of the deregulation of international triangular merger, the attempt to promote foreign acquisition largely failed in the first year. In May 14th 2008, the Cabinet declared there was only one successful international triangular merger since the implementation of international triangular merger one year ago. This lack of international triangular merger is attributed by two factors. First, many vulnerable corporations adopted formal or informal measures to avoid being taken over. Till May 2008, around 500 public traded corporations have adopted defending strategies. This trend significantly prevented the potential takeover bids. Second, the crush of global credit market in the last two years also prohibited potential foreign acquiring firms to launch takeover bids. Because large scale M&A are generally facilitated or even instructed by large financial institutions such as investment banks and private equity funds, the collapse of credit market significantly curtailed their ability to promote international market for corporate control (Economist 05/27/2008; Yomiuri 05/23/2008).

Despite the unsuccessful promotion for international triangular merger, the rising number of M&A and the new threat of foreign acquisition inspired serious debate about whether Japan should adopt Anglo-Saxon model of capitalism. Unlike corporate finance and governance structure that have no direct relation with ordinary employees, corporate restructuring directly threatened the life time employment system that is widely seen as the pillar of the Japanese model of capitalism. Thus the Japanese public paid much more attention to the development of Merger and Acquisition than other

issues. As I mentioned in the first chapter, Japanese scholars and business leaders had fierce debates about the merits and demerits of Japanese capitalist system since 2005. American style market for corporate control was often seen as the core institution of American capitalism and lies at the center of these debates (Niwa and Netarai 2006; Iwai 2006; Nakatani 2005; Tachibanaki 2006). While the advocates suggested that a vigorous market for corporate control is what exactly Japanese corporations need in contemporary global capitalism (Hattori 2006), opponents argued that it will destroy the competitive advantages brought by the traditional system (Takahashi 2005). This is still an ongoing debate among Japanese scholars.

On the other hand, as the Japanese economy showed signal of recovery, Japanese public showed stronger reservation for a more market-oriented system. A series of polls conducted by The Japan Institute for Labor Policy and Training after 1999 showed the changing attitudes among the Japanese public in the last decade. In the poll conducted in 2007, 86 percent of the respondents reported that they favor traditional life time employment system, which is the highest ratio since the survey was first conducted in 1999. In the same survey, 43.2 percent of the respondents believed that priority goal of Japanese society should be income quality, while only 31.1 percent believed that the priority goal should be free competition. This was also the first time more people favoring equality than competition since 1999.[28] It shows that the Japanese public do not accept METI's vision of market for corporate control.

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[28] http://www.jil.go.jp/press/documents/20080324.pdf

6.7 Conclusion

The regulations for corporate restructuring provide the least clear evidence for ideational approach among the three dimensions. Because the reforms between 1997 and 2000 were clearly driven by financial crisis, at first glance the deregulation seemed to confirm the efficiency approach that addressed the inevitability of market-oriented reform. The economic rebound after 2005 also seemed to confirm the proposition that market for corporate control is beneficial to the economy. However, the problematic performance of reform-adopted corporations still presents strong challenge to this argument. Even in the English-speaking world the evidence shows that most M&As end in failure. If the positive effect of market for corporate control is inconclusive, the question shifts from whether the market for corporate control actually improves the performance of corporations to why it is accepted as the solution to economic problems.

On the other hand, the political battle for the international triangular merger revealed the tension between business community and economic bureaucrats, who were believed to have close connections. From the view of the ideational approach, the critical issues are the dominant understandings of the nature of the problem, and the means and end relationship of policy. Economic bureaucrats did not "reflect" on the status quo of the structure; they wanted to transform it. Whether they succeed in the legislative process is contingent on how well they can persuade the politicians of the meaning and desirable outcomes of the reform. Once a policy paradigm is institutionalized in the policy field, the policy purposes and means-end relationship prescribed by it dominate the legislative course, which does not necessarily fully overlap with the power structure.

The conflicts around the international triangular merger show that even the paradigm that was initially supported by the Japanese business community could not avoid conflicts. However, the direction of conflict was shifted. Under the old paradigm the business groups struggled to ease the restriction and gain more flexibility; under the new paradigm they tried to constrain the market.

In short, the transformation of regulations for corporate restructuring still confirms the insight of the ideational approach. Interest groups cannot totally determine the political agenda if they cannot find legitimate purposes. Throughout the 1990s large Japanese corporations challenged the old regime in the name of globalization. They repeatedly argued that the restrict regulations curtailed their competitiveness in the global market. This discourse successfully assisted the institutionalization of the neoliberal paradigm. Ironically, as the rhetoric of globalization turned against them after 2000, they had little if not no leverage to reverse the policy course. The deregulation of the international triangular merger clearly shows this irony.

Ch.7 Conclusion

7.1 Summary of the Findings

This study examines the transformation in Japanese corporate legislation over the last three decades. In contrast to explanations that emphasize the economic environment and political structures, this study focuses on the formation and transformation of the underlying legislative logics. I argue that corporate legislation entails prior understandings of the nature of a corporation and of its relationship with the society. Therefore the policy paradigm that instructs "not only the goals of policy and the instrument that can be used to attain them, but also the very nature of the problems they are meant to address" (Hall 1993) has undeniable impact on the direction of legislation. Policy paradigm shaped legislation in two ways. First, it defines the legitimate purpose of legislation. Second, it instructs the appropriate means of achieving the policy goal.

Unlike what the general belief suggests, this study shows that the Japanese political system had already been troubled by corporate scandals and tried to respond with legislation beginning in the mid-1970s. However, the legislative course of the recent reform deviated substantially from the previous one. By tracing the long-term development of corporate legislation, this study shows that the recent market-oriented reform cannot be separated from the transformation of the policy field of corporate legislation and the resulting paradigm shift in the mid-1990s. Before 1997 the policy field of corporate legislation was dominated by law scholars trained in German legal tradition and bureaucrats in the Ministry of Justice. They viewed a corporation as an association composed of stable shareholders; they also saw it as a quasi-public institution that had a great impact on society. Therefore the corporate governance problem was interpreted as

one of social order; shareholders interests were perceived as the sustainability of the corporation; and the conceived solution of the corporate governance problem was to enhance internal checks and balances.

Since the mid-1990s the policy field of corporate legislation gradually shifted to the hands of economic bureaucrats who treated a corporation as a nexus of contracts constantly negotiated in the financial market. In the neoliberal paradigm the corporate governance problem was interpreted as an issue of economic prosperity rather than social order. Economic bureaucrats believed that the recession in the 1990s was the result of rigid corporate governance, and market-oriented reform was considered the solution to Japanese economic problems. In this process, corporate legislation shifted from a purely juridical issue to part of the economic policy. Accompanied with the movement of structural reform, the neoliberal paradigm was institutionalized in the policy field and led to the recent market-oriented reform.

I further examine how this paradigm shift shaped regulations for corporate finance, governance structures, and corporate restructuring. In terms of corporate finance, I examine the regulations for share repurchase, stock options, and minimal capital and found resulting radical changes. Under the jurist regime, share repurchase was perceived as a potential source of seal dealing and financial turbulence. It was thus generally banned until 1993. Even in 1993 when the ban was lifted to alleviate the damage brought by the burst of the bubble, the Ministry of Justice still insisted on imposing strict financial and procedural requirements to restrain the adoption of share repurchase. However, after the paradigm shift in 1997, share repurchase was viewed by the economic bureaucrats as a positive measure to raise shareholder values. Therefore, the restriction was radically

deregulated and share repurchase was formally recognized as a normal financial operation. The second issue is the deregulation of stock option. Before the 1990s Japanese corporate law only prescribed the preemptive right to purchase newly issued shares. Law scholars and MOJ bureaucrats were uncomfortable about the potential turbulence resulting from an independent option market. In early 1980s when the warrant bond was deregulated, the Ministry of Justice avoided establishing an option market by restrictively constraining the separation between bonds and preemptive right. After the mid-1990s economic bureaucrats viewed the stock option as an important policy tool to encourage innovation and reform corporate governance. Through a series of legislation in 2003, the option market was formally legalized in Japanese corporate law. The regulation and deregulation of minimal capital present the most drastic examples of the impact of the paradigm shift. The requirement of minimal capital during incorporation was virtually absent before 1990. However, law scholars and MOJ bureaucrats saw this lack as a potential source of abusing the limited liability prescribed in corporate law. They first raised this issue in 1974 and finally completed the legislation in 1990. However, only one decade later this requirement was perceived as an obstacle to venture capital that is crucial for innovation. In 2002 the economic bureaucrats abolished the requirement for minimal capital.

The second dimension is the regulations for governance structure. Although the purpose of corporate law since the beginning has been protecting shareholders, the definition of shareholders interests and the corresponding measures changed with the paradigm shift. Under the jurist regime, a corporation was seen as an association composed of stable shareholders; thus shareholders interests were identical with

shareholders rights within the corporation. The regulations for governance structures concentrated on enhancing internal checks and balances among corporate organs; the solution to corporate governance problems was allocating more rights to the general meeeting of shareholders and auditors and tightening the regulations for the board of directors. However, after 1997 the legislative logic changed radically. Because a corporation was treated as a nexus of contracts, the shareholders and the executive branch were treated as parties in a contract who could determine their best interests through negotiation. Therefore shareholders interest was defined as the fair term in corporate contracts. The strict rules for governance structure, which were designed to protect shareholders in the old paradigm, were treated by the economic bureaucrats as an obstacle to the optimal arrangements among shareholders. Thus the new corporate law deregulated the rules and prescribed more options for governance structures; on the other hand, because protecting the fair term in the corporate contract was perceived as protection for shareholders interests, board independence and information disclosure to the financial market became the central issues of legislation. These two issues challenged the Japanese business community's traditional practice and met strong resistance. Although the legislation was seriously compromised, these two measures nonetheless entered the new corporate law.

The third dimension is the regulations for corporate restructuring. An important feature of Japanese capitalism is the lack of hostile takeovers and extremely low ratio of merger and acquisition activities compared with other industrialized countries. The old corporate law prescribed strict procedural and financial requirements for merger, divestiture, and acquisition. The burst of the bubble in 1990 created an urgent need for

restructuring among large Japanese business groups. Allying with business groups, economic bureaucrats led the legislation to facilitate domestic merger, acquisition, and divestiture between 1997 and 2000. However, after 2000 this alliance was broken when economic bureaucrats tried to further promote international mergers, which had long been a taboo in the Japanese business community. Despite strong resistance, economic bureaucrats successfully convinced politicians of the necessity of introducing foreign capital.

In short, this project provides clear evidence that the dominant policy paradigm influences corporate legislation. In other words, this project proves that corporate legislation entails collective understandings about the nature of a corporation and its relationship with the society. Therefore, the long term institutional development cannot be separated from the ideational frameworks shared in the policy field

7.2 Counterfactual Propositions

To further demonstrate the findings, this study constructs counterfactual propositions to compare with the actual case. A critical question for this study is: what would happen if the policy field of corporate legislation was still dominated by the jurist regime? This study suggests that for two reasons if the paradigm shift did not happen, the Ministry of Justice may have conceded to business groups in single issues, but the systematic amendments of corporate law after 2000 would not occur. First, law scholars and many ex-leading MOJ bureaucrats strongly disagreed with the recent legislation. The best evidence is Inaba Takeo's criticism of the plan "Modernizing Corporate Law." Inaba Takeo is a veteran MOJ bureaucrat who worked on corporate legislation for about

fourteen years and took charge of the early stages of the legislation for minimal capital. He left Ministry of Justice in 1988 and served as a judge in the Tokyo High Court. In 2003 he retired from the position of senior judge and currently serves as a law professor at Waseda University. Inaba is among the most outspoken critics of the recent reform. His criticism can be summarized as follows. First, he accused the recent reform as blind adoption of American institutions without considering the reality of Japanese society. He argued that Japanese corporations lacked the tradition of self-restraint and thus strict rules are essential for ensuring the fairness of the whole system; in his metaphor, corporate law is similar to the safety regulations for automakers. The deregulation of corporate regulations is equivalent to easing the safety regulations for automakers, which would appease drivers in the short run but create more chaos in the long rum. The new corporate law, he suggested, inappropriately deregulates the necessary rules and thus would create chaos in the future.

Second, Inaba also strongly criticized the abolishment of the principle of capital. He argues the abolishment of minimal capital will not only hurt creditor's interests but also damage the consistency of corporate law. Although the principle of capital is largely abolished in the United States, Inaba argues that the European model, in which the principle of capital is still preserved, is a better model for Japan. Third, he also criticized the liberalization of the corporate constitution. He argued that this liberalization will damage minority shareholders and creditors because it gave controlling shareholders even stronger power for appropriating the corporate constitution. Finally, he criticized

the confusion created by the internal control system and one-tier board. He insisted that the superiority of the two-tier board differentiates the functions of monitoring and decision making (Inaba 2006).

Inaba's views are shared by many law scholars and MOJ bureaucrats. The only issue is that these like-minded scholars were marginalized in the legislative process after 1997. Without the transformation of the policy field, bureaucrats with similar backgrounds and ideas will still keep dominating the legislative process as they did before the mid-1990s. If they still retain the status of "gatekeeper" in corporate legislation, it can be expected that much of the reform will not enter the legislative process. On the other hand, although politicians successfully challenged the Legislative Council and MOJ and deregulated stock options in 1997, the later development showed that they lacked the capacity to systematically amend corporate law. If MITI did not develop the neoliberal paradigm and transform the policy field, politicians would still have to rely on scholars and bureaucrats who believed in the jurist paradigm. The radical transformation would face strong resistance and was less likely to happen.

7.3 Efficiency, Power and Ideas

The core question of this project is how do efficiency, power and ideas shape corporate law? It seems reasonable to assume that corporate law has to improve economic efficiency. Since a democratic government has to respond to the economic conditions, corporate legislation is a feasible policy tool. In this case, the fact that the movement of structural reform emerged amid the biggest economic crisis in postwar

Japan shows the influence of the economy on corporate law. On the other hand, it is also reasonable to assume that those who are influenced by corporate law would mobilize to change the law. In this case we do observe the political mobilization of business groups in the corporate legislation.

Table 12: Examining Power and Efficiency Approaches by the Japanese Case

	Predictions of the Power Approach	Predictions of the Power Approach	Legislative Outcome before 1997	Legislative Outcome after 1997
Corporate Finance	Loose regulation	Loose regulation	Strict regulation	Deregulation
Governance Structure	Unclear	Loose regulation	Strict regulation by general meeting of shareholders and auditors	Strict regulation by board independence and internal control
Corporate Restructuring	Loose regulation for both domestic and international restructuring;	Loose regulation for domestic restructuring; strict regulation for international restructuring	Strict regulation for both domestic and international restructuring	Deregulation for both domestic and international restructuring

However, this project shows the limitations of these two approaches. Both approaches skip the concrete process of drafting, deliberating and debating the bills and directly link the legislation with structural forces. As this project shows, this process is essential for the long-term institutional evolution. Indeed, politicians' need interest groups' direct political support and have to respond to voters' concern for the economy. Nonetheless, they do not legislate in a vacuum; they legislate in complicated fabrics of laws. They also have to make sure the desirable outcomes of their actions. Therefore,

they have to rely on policy experts who have often their own beliefs, preferences and even agendas. In other words, the beliefs carried by these policy experts in this process inevitably influence the contents of legislation. This case shows that when interest groups' requests could be backed by the dominant paradigm or when the neoliberal paradigm is dominant in the policy field, politicians do behave as what the power approach or the efficiency approach predicts. However, when this is not the case, the legislation deviates from what the two approaches predict.

In short, this project refutes the interest based models that see public policy as the pure extension of personal calculation. However, it does not deny the impact of power and efficiency; rather it suggests a more sociological understanding of them. Both efficiency and power are socially constructed; Fligstein (1990, 2001) has shown that even in the private sectors efficiency is constructed by relevant actors; in his classical theorization of power, Lukes (2005) also argues that agenda setting is an implicit but often more influential way to exercise power. This version of efficiency and power is consistent with the findings of this project; the struggle between ideas in the policy field, which is overlooked by the interest based models, is crucial for the legislative course. The impact of ideas, power and efficiency should be located in the concrete social world where a bill is drafted, deliberated, and debated.

7.4 The Transformation of the Japanese Developmental State

The importance of the unique model of Japanese political economy, namely the developmental state, cannot be emphasized more. Students of Japanese political

economy have long noticed that Japanese government played an active role in transforming Japanese economy (Johnson, 1982). Recent studies have shown that the traditional model of developmental state had faded as Japan became an economic superpower (Callon 1995). Especially after the economic crisis in the 1990s, researchers began to look for the new model succeeding the developmental state. The recent findings show that although strong resistance prevented any attempt to radically transform the system, the Japanese government, despite its own turbulence, did adjust the institutional infrastructure in a slow but steady fashion after 1990s (Vogel 2006; Tiberghien 2007 Hiwatari and Miura 2002). Although Koizumi did show uncompromised determination to transform Japanese politics and economy, much of the reform was actually planned or even passed before he took office (Uchiyama 2007). Some of these adjustments even hurt their constituencies' interests and cost them political support (Noble 2006). This project confirms this finding; a great portion of the corporate legislative reform were planed before the Koizumi cabinet and conflicted with business groups. How to account for this puzzling picture of structural reform?

Furthermore, the role of economic bureaucrats in the structural reform is also confusing. On the one hand, economic bureaucrats still play a important role in shaping Japanese economy. Although they lost the administrative power of intervening with the private sectors, they influenced the Japanese economy through assisting political leadership to form economic plans. On the other hand, their new policy orientation undermined the very rationale of their existence. Johnson (1982) distinguishes two types

of state in capitalist economy: the regulatory state that concerns itself with the forms and the procedures of market competition, and the developmental state that concerns itself with substantive social and economic goals. Ironically, this distinction is blurred as Japanese economic bureaucrats treated enhancing market competition as their substantive economic goals. How to account for economic bureaucrats' paradoxical role in the last decade?

This study provides a new angle to these issues. The literature of Japanese structural reform often focuses on the political process of reforms (Pempel, 1998; Mulgan, 2003; Tiberghien, 2007). Although its importance cannot be emphasized more, it leaves the question where the reform projects came from. Just as the developmental state cannot be separated from the economic ideology of developmentalism (Gao 1997), the structural reform also cannot be separated from the neoliberalism. Although it is absolutely true that Japanese economy is operated by complicated and intervening institutions that resist radical change, one should not underestimate the potential impact of a coherent ideology that provides an available solution to the economic problem, no matter whether the solution works. As Japanese public lost faith in their institutions during the economic crisis, the neoliberal ideology carried by the young generation gained the political support in a variety of fields. When the underlying ideology changes, the same set of institutions may function differently. The interaction between ideas and institutions deserves more attention.

7.5 Globalization and Ideational Diffusion

One of the most important ongoing debates in the social sciences is whether global economy eliminates institutional diversity across countries (Dore and Berger 1996; Soskice and Hall 2001). Although students of comparative political economy widely reject the claim that diverse political economies are converging on one single model, they nonetheless agree on the recent prevalence of neoliberal policies that prioritize the market as the main mechanism that governs a variety of fields (Streeck and Yamamura 2001, 2003; Streeck and Thelen 2005). In many places the postwar social contracts that led to social peace were dismantled through the victory of right-wing parties (Pierson 1995); and the mixed economy characterized by active state intervention in the market was replaced by a more market-oriented regime (Witold et al. 2007). Organized labor kept losing their political influence, and states were forced to compete for investment. Although the scale and scope of changes varies across countries, the changing policy course is indisputable. Thus many observers argue that advanced political economies have experienced regime shifts that redirect the course of economic and social policies.

The Japanese corporate legislative reform is an important case of this global trend. Increasing social scientists, especially sociologists, find that neoliberal policies often appeared before or even without the emergence of corresponding political economic structures. Studies on the postcommunist transformation of Eastern Europe show that market-oriented reforms were driven by intellectuals with beliefs in neoliberal ideas (Szelenyi et al. 1998). Work on the formation of the derivative financial market has also found that they are actually created, not explained, by economic models (Mackenzie and

Millo 2004). Even in countries where neoliberal policies have historical roots, studies show that ideas have a critical role in justifying policy choices (Sommers and Block 2006). A recent study also finds that domestic political economic structures and cultural origins can predict little about the adoption of neoliberal policies (Heinisz, Zellner, and Gullien 2005).

This study confirms this sociological insights on the global diffusion of neoliberalism. This case shows that ideational globalization is at least as important as material globalization in shaping national institutions. Japan has long been famous for the lack of a market of corporate control; however, once it is seen as a problem rather than as a national characteristic, this lack becomes the target of reform. Neoliberalism is not merely involved with material factors such as the changes in resource allocation and styles of intervention; it implies a way of perceiving the world. The term "reform" implies judgments about existing institutions. The political and economic approaches that focus on the status quo conditions fail to capture the fact that policymaking is about projection toward the future, and different projections create totally different actions. In this sense neoliberalism does not merely provide a way to cope with the economic environment and political power, but rather aims to create a reality that transforms the existing environment. Once neoliberalism becomes the dominant way of perceiving the economy, it becomes part of the "social reality" in the global economy. As large financial institutions, international organization, mass media and other influential actors

increasingly follow the "repertoire" prescribed by neoliberalism, the market oriented reforms are more likely to be taken for granted.

7.6 Limitation of this Study and the Future Research Agenda

This project leaves several important questions. First, will Japanese corporate governance be successfully transformed by the market oriented reform? Although corporate legislation do bring changes to corporate governance, it does not determine the way of changes. Quite often organizations respond in the way that is unexpected by the designer. Especially some part of the reform, such as the deregulation of international M&A, was strongly resisted by the Japanese business community; whether Japanese corporate governance will move toward a more market oriented model is still uncertain. Because the new corporate law was only implemented for two years, it is premature to reach any conclusion. The answer of this question will have strong implications for the studies on corporate governance.

Second, how unique is the Japanese case? Can we find a global diffusion of corporate legislative reform that similar to what happen in Japan? The major weakness of this study is that it only deals with one single case. Thus whether corporate law in these countries is also substantially changed is crucial for the applicability of this project. Some recent studies find that European countries also experience market oriented reforms in the last decade (Davis and Marquis 2005; Jackson 2003). Whether corporate law in thee countries experienced similar changes is an important question for future study.

Finally, how unique is corporate law? Corporate law may not be the only sphere that experience a market oriented transformation. In Japan another sphere experienced market oriented reform is the accounting regime (Morimoto 2002). Even in the United States, the financial regulatory regime founded after the Great Depression has been substantially transformed in the last two decades. Coincidentally but not accidently, the financial regulatory system in the United States also moved toward a more market oriented scheme in the same period of Japanese corporate legislative reform. The answer of this question will help us better understand the nature of contemporary global capitalism and its future.

Appendix I

Japanese Corporate Legislation: 1974-2006

Year of Effectuation	Number of Legislation	Content
1974	Legislation no.21, no.22, no.23[29]	Retrieving Auditor's right to monitor executive affairs
		Shifting the power of issuing convertible bond from general meeting of shareholders to board of directors
		Requiring Large Corporations (book capital higher than five hundred million yen) to appoint licensed accountant for accountant auditors
1981	Legislation no. 74, 75	Rising the book value of a share increase to fifty thousand yen
		Granting shareholders the right to raise proposal in general meeting of shareholders
		Granting shareholders the right to question directors in general meeting of shareholders
		Granting auditors right to call the meeting of board of directors
		Disclosing operational report and accountant repost to shareholders
		Requiring regular auditor
		Accounting report must be acknowledged by general shareholder meeting
		Legalizing absentee vote in general meeting of shareholders
		Deregulating warrant bond
1990	Legislation no.64, no.65	Requiring minimal capitalization in incorporation
		Deregulating shares with transaction-restrained
		Deregulating primary shares
		Expanding the minimal amount of corporate bond
1993	Legislation no.62, no.63	Lowering the collateral of shareholders derivative actions
		Lowering the threshold for accountant inspection
		Extending the term of auditor from two years to three years
		Increasing the minimal number of auditors from two to three
		Requirement for independent auditor

[29] A package of amendments passed in the same time is labeled as the same legislation.

1994	Legislation no.66	Deregulating share repurchase
1997	Legislation no.72	Abolishing the reporting general meeting for merger
		Simplifying the procedures of notification to creditors for merger
	Legislation no.55, 56	Deregulation of Stock option
1998	Legislation no. 11	Special law for deregulating share repurchase
1999	Legislation no.125	Deregulate share exchange
		Deregulate Share transfer
		Auditors are allowed to inspect the accounts of subsidiary companies
2000	Legislation no. 28	Special law for deregulating share repurchase
	Legislation no.90	Deregulating corporate divestiture
2001	Legislation no.79, no.80	Legalizing share repurchase
		Abolishing par-value
	Legislation no.128. no.129	Legalizing call option
		Legalizing electronic voting
		Requirement for electronic disclosure
2001	Legislation no.149	Reduction of directors liability
		Extension of auditor's term to four years
2002	Legislation no.44	Introducing company of committees
2003	Legislation no.132	Deregulating share repurchase
2004	Legislation no.87	Legalizing Digital notification
2005	Legislation no.86	Abolishing minimal capitalization
		Simplifying procedures of restructuring
		Deregulating corporate charter

Appendix II

The Formal Structures of Corporate Law the Variance of Corporate Regulations

The core feature of modern corporation, legal personality, is arguably one of the most important institutional innovations in human history (Weber 1978; Coleman 1991) The Law Merchant (*lex mercatoria*) that was originally a body of rules and principles laid out by merchants themselves to regulate their dealings in the eleventh century contained the notion that an economic organization can be seen as a legal entity separated from its constituencies (Berman 1983). Joint-stock corporations with limited liability first appeared in sixteenth-century England, when the East India Corporation, Bank of England, and the notorious South Sea Corporation were incorporated by Royal Charters. The vigorous transaction of its shares can be seen as the beginning of transferable shares and initialized the London stock market, which later became the global financial center (Carruthers, 1996). In the United States, semi-public railroad corporations in nineteenth-century America were also first chartered by specific laws to ensure that these corporations fulfilled their duty to the public (Roy, 1997). These institutional innovations were gradually consolidated and spread to other places. Since the late nineteenth century, major industrialized countries gradually formed similar corporate law to regulate joint-stock corporations. In most capitalist countries, corporate law shared the five formal structures: legal personality, limited liability, transferable shares, delegated management, and investor ownership. These rules are stated as follows:

a. Legal personality: legal personality refers to the corporation's independent legal status from the various individuals who own or manage it. A corporation is entitled to make contracts, own assets, and launch relevant lawsuits as a natural person.
b. Limited liability: limited liability refers to the principle that the creditors are limited to making claims against the assets that are owned by the firm, and have no further claims against the firm's shareholders or managers. This principle makes the corporation a convenient means to share risk and secure the property of the shareholders.
c. Transferable share: transferable share refers to the principle that the change of owners does not influence the corporation's legal status and the legal affects of its behavior. This principle permits the firm to avoid the complications of member withdrawal and create financial markets. It also enhances the liquidity of shares.
d. Delegated management: delegated management refers to the rule that the authority of decision making is delegated to specific individuals. Corporate law generally vests principle authority over corporate in a board of directors or similar committee organs that are periodically elected by shareholders and are formally separated from operational managers. This feature allows corporations to employ professional management.

e. Investor ownership: investor ownership refers to two rights held by the shareholders. First, shareholders are entitled to receive the corporation's net earnings. Second, shareholders formally own the ultimate power of controlling the corporation. Shareholders hold the right to vote in the election of the director or in important transactions. This rule defines the ultimate property right of the corporation (Hanmann and Kraakman 2005; Clark 1986).

The Limits of Formal Structures and the Variance of Corporate Regulations

Table 13: Issues of Corporate Legislation

Governance Structure	Corporate finance	Incorporation, dissolution, and corporate restructuring
Function of the board	Legal status of diverse financial schemes	Minimal capital for incorporation, and corporate constitutions
Composition of the board	Procedural requirements for scheme of corporate finance	Rules for reorganization and liquidation
Allocation of rights	Substantial restrictions on financial scheme	Rules for merger and acquisition
Shareholders rights Call for general meeting and inspection of the corporate account		

Despite the common formal structures, for two reasons there are still substantial variances in actual legal arrangements across time and countries. First, formal structures are abstract and incomplete in nature; they only define the basic principles and leave the substantial regulations to more concrete rules (Sutton 2001). This room allows

lawmakers in different times and spaces to develop different legal arrangements for defining these principles and coping with problems. Second, the changes of environment constantly pose new challenge to the existing regulatory system. According to organizational ecology, organizations cannot fully catch up environmental change and are inertia in nature (Hannan and Freeman, 1984). This is also the case for the corporate regulatory system; social actors constantly invent new practices and inevitably challenge the existing system. No regulatory system can fully control the practices and thus have to be frequently adjusted. Legal arrangements of corporate regulation in advanced capitalist countries vary in the following dimensions:

(1) The governance structure of a corporation. The arrangements vary in the following dimensions:

a. Function of the board(s): some legal systems, like Japan and Germany, require corporations to build a two-tiered board system and differentiate the functions of monitoring and decision making. On the other hand, in the U.S. system a single board of directors that performs both the functions of important decision making and monitoring.

b. Composition of the board(s): despite the general principles that directors are elected by shareholders, there are different rules about the composition of the board. Labor unions and independent directors are two important types of members. In Germany half of the board of auditors is appointed by the labor

union, while in the United States the appointment of independent directors is increasingly institutionalized among publicly traded companies.

c. Procedures for important transactions and decisions: although most decisions on executive affairs are delegated to the managers, corporate law generally requires specific procedures for important transactions or decisions. The same types of important decisions may only need to be resolved by the executive branch, or need to be passed by the board of directors, or in general meeeting of shareholderss. The differences in procedures of certain actions may substantially influence their eligibility.

d. Rights of shareholders: despite the general principles of investor ownership, the substantial contents of ownership also vary. Jurisdictions differ in the rights that individual shareholders are entitled to, the threshold and procedures of exercising these rights, and the power of the general meeeting of shareholderss.

(2) Second, the regulations of corporate finance also vary in the following dimensions:

a. Legal status of the financial scheme: an important development for the modern corporation is constant financial innovation. On the one hand, these financial innovations can enhance the liquidity of corporate assets and encourage risk-taking activity. On the other hand, they also create unprecedented systematic risk and provide room for large-scale fraud and managerial expropriation. These financial schemes include different types of corporate bonds (ordinary bonds, convertible bonds, warrant bonds); a variety of derivative financial schemes

(stock options); and other operations of equity such as share repurchase. Governments have to define the legal status of these financial schemes.

b. Procedural requirements for financial schemes: even if the government legalizes certain financial schemes, a critical issue is still the procedures through which a corporation is allowed to adopt them. Two types of procedural requirements exist: the first is internal procedures within the corporation. The variance lies at whether the adoption of certain financial schemes can be decided on by executive branches, or need the resolution of the board of directors, or even that of a general meeeting of shareholders. The second type of requirement is governmental regulation. Jurisdictions differ in whether corporations are only required to inform the authorities or need to obtain the permission before adopting financial schemes.

c. Substantial requirements for financial schemes: in addition to the procedural requirements, jurisdictions also differ in the substantial requirements of financial operations. These rules include which part of corporate assets can be appropriated in financial operations, under which conditions corporations are allowed to adopt these financial schemes, and the amount of cash that can be invested.

(3) Third, despite normal operations, corporate law also plays an important role in the formation, dissolution, and restructuring of corporations. Theses rules differ in the following dimensions:

a. Rules of incorporation: rules of incorporation diverge in the requirements of minimal capital, procedural requirements, and corporate constitutions. Some jurisdictions require minimal capital for incorporation to ensure that creditors receive minimal protection. The second issue for incorporation is the allocation of right and duty among corporate constituencies. Some jurisdictions require new corporations to follow strict rules established by the government, while some jurisdictions, especially in the United States, only provide facilitating rules; shareholders are allowed to form their own charters to allocate the rights based on agreements.

b. Insolvency regime: the very fact that firms can fail and go bankrupt is a critical feature of capitalist economy (Halliday and Carruthers 2007). The so-called corporate insolvency regime, which is composed of the rules of liquidation and reorganization, also varies across jurisdictions. Potentially every type of economic actor in the market will be influenced by the insolvent regime. Jurisdictions differ in how creditors are protected, how shareholders rights are defined, and the responsibility of controlling shareholders and managers.

c. Corporate restructuring and markets for corporate control: despite incorporation and dissolution that mark the birth and death of corporations, corporations also experience fundamental restructuring through mergers, acquisitions, and divestiture. The rules of corporate restructuring also vary across countries and change over time. Jurisdictions differ in the procedural requirements and the

financial schemes of restructuring that are allowed. These rules are especially important for the markets for corporate control. These rules determine how easily corporate restructuring can be implemented and the development of markets for corporate control. For example, it would be more difficult for corporations to implement restructuring when the decisions are required to be passed in a general meeting of shareholders. On the other hand, regulations for the financial scheme in merger and acquisition strongly influence the development of markets for corporate control. The loose regulation on a high-leveraged financial scheme is a precondition for a vigorous market for corporate control. It is relatively difficult to launch M&S if corporations are not allowed to borrow from banks or use stocks as the financial scheme for M&A.

In short, substantial variance in legal arrangements still exists, even under the same formal structures. This creates room for national diversity and historical transformation of corporate law.

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■ Publications

Yoshida Kenzo, Yung-Shin Guo and Li-Hsuan Cheng 2006 "Japanese Pension Reform of 2004: A New Mode of Legislative Process." *Asian Survey* Vol. 46 Issue.3 p.381-402.

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Conference Paper

2004 "Labor Market Structure and Fertility: the Comparison of Taiwan and South Korea" paper present in Annual Meeting of American Sociological Association, San Francisco, CA

2007 "Ideas and Corporate Legislation: the Case of Japan" paper present in Annual Meeting of American Sociological Association, New York City, NY

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