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## On a Different Path? The Managerial Reshaping of Japanese Corporate Governance

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### Introduction

The chapters in this book address the state of Japanese corporate governance and managerial practice at a critical moment. They are mostly based on detailed and intensive field work in large Japanese companies and on interviews with investors, civil servants, and policy makers in the period following the adoption of significant corporate law reforms in the early 2000s up to the months just prior to the global financial crisis of 2008. Among the legal changes made during this period were reforms which, with effect from April 2003, allowed firms to opt into a “company with committees” structure based, loosely, on American practice, with provision for an enhanced role for independent directors. At around the same time, several high-profile takeover bids attracted public concern and challenged the perceived wisdom that hostile takeovers were impractical in Japan, giving rise to a series of court rulings and attempts by the industry and justice ministries to generate consensus on guidelines for companies involved in such takeovers. In the decade prior to these developments there had been a steady rise in foreign share ownership, a decline in the cross-shareholdings which had insulated large firms from capital-market

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pressures, and the erosion of the practice of bank-led monitoring of corporate performance. Above all, there had been the massive disillusionment of the post-“bubble” years, when a stream of scandals and corporate failures throughout the 1990s and beyond called into question the integrity of Japan’s entire postwar system of corporate governance. The time seemed right for Japan to make the final move to a market-driven, “Anglo-American” system of corporate governance.

Almost a decade later, the picture looks rather different. Although listed companies make greater use of external directors than before, few have taken up the company with committees option. The hostile takeover movement has stalled, with firms taking advantage of the evolving state of the law to put in place antitakeover defenses and, in some cases, reconstruct cross-shareholdings. Activist shareholders, both pension funds and hedge funds, have had mixed success and some significant rebuffs. Meanwhile, despite a growth in the numbers of temporary and part-time workers, the practice of lifetime employment (best understood as a nonlegally binding commitment on the part of large firms to providing stable, continuous employment to core workers) has persisted, together with a renewed emphasis on employee voice as an intra-firm mechanism for ensuring managerial accountability.

It is possible to interpret this process as the unnecessary prolongation of a period of transition, which will eventually see Japanese practice converging on what has come to be generally understood as the global template for corporate governance. Alternatively, Japan’s experience may be telling us a story about the distinctiveness of national “varieties of capitalism,” even in the face of global pressures. The work we will present in this book suggests that neither of these contrasting images of “transition” and “resistance” very well captures what has been happening. The idea of a partial, possibly stalled transition to the Anglo-American model is hard to square with the continuities we observe in terms of the “internal” orientation of Japanese management, its commitment to employment stability for the core workforce, and the relatively limited influence of shareholders. But nor is it the case that large Japanese firms have simply been resisting pressure mounted from outside by investors and corporate governance reformers. On the contrary, shifts in the legal and institutional framework, as well as the competitive environment, have been the trigger for some far-reaching changes to organizational structures and management style. An adjustment, and in some senses a renewal, of the postwar model of the large Japanese corporation has taken place, not in spite of the legal, institutional, and competitive changes of the early 2000s, but, paradoxically, because of

them, at least in part. The legal reforms were a catalyst or trigger for changes to corporate practice which helped to reinforce a model that they had been expected (by some, at least) to displace.

The aim of this chapter is to put the subsequent, more detailed case study chapters in context, and to set out the book's main themes and findings. The following section considers the institutional origins of the postwar model of Japanese corporate governance and the next one outlines the pressures for change which operated on that model in the period following the bursting of the "bubble" up to the early 2000s. The section after that, drawing on the chapters contained in this book, looks at specific factors at work in the process of adjustment which large Japanese companies have been undergoing since the start of the period of our study in 2003. The final section offers an evaluation of Japanese developments in a comparative perspective and draws out some of the implications of the Japanese case for the wider understanding of global trends in corporate governance.

### **Institutional Origins of the Postwar Model**

The model of corporate governance which emerged in large Japanese companies in the period of sustained postwar growth that ended with the bursting of the "bubble" at the end of the 1980s was one which appeared to be highly stable, was rooted in specific national practices, and, notwithstanding its distinctiveness, was efficient in the sense of providing a framework for the growth of a corporate sector which was highly competitive in product market terms and successful in generating secure and well-paid employment for a sizable core of employees. This model came to be understood as the result of interaction between a number of complementary institutions. Capital markets were relatively illiquid, with extensive corporate cross-shareholdings, limited voice for external shareholders, and passive institutional investors (Sheard 1994). By contrast, there was a prominent role for mechanisms of so-called relational finance, such as bank-led monitoring, and internal financing channelled through group-level holding companies (Aoki 1994). Within the organizational structure of the "community firm" (Dore 1973; Inagami and Whittaker 2005) labor relations were arranged around lifetime employment, company unionism, and internal promotion of management. In various ways, finance and labor complemented each other to favor the emergence of firms which were strongly growth-orientated, and

committed to generating internal capabilities over the longer term. Management had considerable autonomy within a system of “contingent governance” in which banks, holding companies, or, occasionally, government ministries might intervene at points of crisis (Aoki and Patrick 1994), but in which there was little experience of the continuous monitoring through capital-market mechanisms of the kind which were developing in the United States and Britain toward the end of this period, most notably through hostile takeover bids and the growing role within boards of external, independent directors.

One of the most striking features of this model was its apparent lack of visible institutional support. Japan’s corporate law during the middle decades of the twentieth century was contained in the Commercial Code of 1899, which had been based on the German civil law of the late nineteenth century. The Code was revised in 1950 under the influence of the policies of the General Headquarters (GHQ) of the Allied Occupation, thereby incorporating a number of elements drawn from the US corporate law of that time (West 2001). The Japanese joint stock company was one in which the ultimate governing body consisted of the shareholders in general meeting; they had the power to appoint and remove directors on a simple majority vote, and to pass special resolutions with a two-thirds majority. The board of directors was the organ vested with executive powers and the responsibility for running the company as a business. Thus the basic legal form of the Japanese firm was (and is) no different from that which prevailed in most other developed economies. It was only distinctive in a few respects. One of these was the institution of the statutory or corporate auditors. This body, which predated the 1950 reforms, was given the responsibility for overseeing the board’s conduct of the company’s business as well as various accounting matters, and could demand information from the board. The 1950 changes limited its supervisory powers to accounting issues, partly in order to emphasize the board’s responsibility for overseeing management. In the mid-1970s, some of the powers of the corporate auditors were restored as a response to high-profile failures and scandals. The corporate auditors can be seen as playing a similar role to the supervisory board in the two-tier structure which is normal in German-origin systems. However, the Japanese structure was not, formally, a two-tier board as the German one was, and the powers of the Japanese auditors were much more limited than those of the German supervisory board. There was no provision for employee-nominated directors or auditors, or, more generally, for labor-management codetermination on German lines. There was also

no equivalent in Japanese labor law to the legal support for employee voice through works councils which characterized the German model.

Thus the main elements of the Japanese model – bank-led monitoring, executive-dominated boards and a strong orientation, in terms of managerial style and value, toward the interests of core employees – were in no sense legally mandated, or even very much encouraged by the legal and institutional framework. The legal structure of the Japanese firm was, on the face of it, based on the principle of shareholder sovereignty, admittedly with the delegation of executive authority to the board, but with shareholders no more disadvantageously treated than elsewhere in industrial economies; indeed, in many respects, they enjoyed at least equivalent or possibly superior rights (West 2001). Japanese corporate governance practices were (and remain) “context dependent” (see Chapter 8), that is to say, shaped by the interaction of a number of complementary mechanisms operating beyond the reach of the legal framework, rather than being institutionally underpinned as they are, for example, in the German case.

At the same time, the origins of the postwar system owed much to the particular institutional trajectory of Japanese corporate governance in earlier periods. Between the wars, Japan had had active shareholders in the form of large, mostly family-owned blocks, who were capable of exercising direct control over management, and, for much of the time, a liquid capital market, which listed companies accessed for external financing on a regular basis. This picture began to change with the shift to a planned economy during wartime, when dividend controls were introduced and the authority of company presidents was enhanced at the expense of shareholder influence. These changes were brought about by a mix of legislation (most notably the Munitions Corporation Law of 1943), governmental regulation, and administrative direction which, while not formally bringing about a revision of the Commercial Code, substantially qualified its effects in practice. Executive boards replaced shareholder-dominated ones, and the practice of internal promotion of managers to board level became more widespread. At the same time, the main bank system was taking shape with the development of loan consortia organized under government and central bank auspices. The effects of these changes were that, by the end of the war, “stocks and shares became in effect fixed interest-bearing securities, and profits remaining after the fixed dividend had been paid were distributed among managers and employees in a profit-sharing system” (Okazaki 1999: 120). Laws on corporate restructuring passed during the GHQ period maintained this trend, and even with the more market-orientated Dodge Plan from 1949

onward there was a focus on bank-led monitoring and the integration of core employees into the decision-making structures and values of the firm. The effect was that by the early 1950s, “a pro-growth corporate governance structure had been formed, its major players being growth-oriented lifetime employees and a similarly growth-oriented financing body of investors centred around a main bank” (Okazaki 1999: 138).

The way in which the component parts of the postwar model complemented each other was dependent to some degree on the contingencies and accidental diversions of the historical path which the Japanese economy and society had undergone during the wartime years and the years of allied occupation. However, it was also the case that “the major constituent elements of the Japanese system were deliberately created” in this period (Okazaki and Okuno-Fujiwara 1999: vii), against the background of policy debates which made the suppression of shareholder interests explicit. By the 1960s, formal controls over dividends and restrictions over mergers associated with the postwar reconstruction period had long been removed, and the legal structure associated with the Commercial Code revived. But this legal framework, which was in any event largely facilitative rather than prescriptive, proved to be entirely compatible with the practice of managerial autonomy from shareholder control, at least until the bursting of the bubble in the late 1980s.

### **Pressures for Change in the 1990s**

In the so-called “lost decade” of the 1990s, although there were significant legal reforms relating to share repurchases, stock options, and the use of holding companies, among other things, there were few significant legal changes directly related to corporate governance. However, the component parts of the corporate governance system underwent a number of overlapping and interconnected modifications as the nature of the economic environment changed. There was, first of all, the eclipse of bank-led monitoring, as the rolling over of loans by banks faced with financial distress (both of the companies to which they lent and, increasingly, of themselves) made bank-led intervention in corporate affairs less credible. The weakening of bank-led monitoring may have led client firms to postpone restructuring and helped to stabilize employment during a period of prolonged low growth (Arikawa and Miyajima 2007: 75).

Secondly, cross-shareholdings began to decline, but not uniformly. Their extent decreased most quickly in firms in which bank lending was

becoming less significant, but was maintained by firms with continuing links to a main bank. More profitable firms which made greater use of external finance through the capital market, and which tended to have a larger proportion of overseas shareholders, began to unwind previously stable cross-holdings, while less profitable ones tended to keep them (Miyajima and Kuroki 2007).

Thirdly, with growing foreign ownership, there came a shift in investment style and practice. Foreign shareholders, who mostly acquired stakes in larger, export-orientated and higher-performing firms (initially at least), were investing for financial returns, in contrast to traditional Japanese investors who had tended to have relational commitments; institutional investors often had ties to a main bank while corporate pension funds would tend to hold shares in business partners of the company sponsoring the scheme. Foreign holdings were more liquid in the sense of being frequently traded, so that a small stake in nominal terms could acquire a larger significance in terms of its impact on share price movements. Foreign ownership was also associated with downsizing, although the direction of causation was unclear (Ahmadjian 2007: 145): were mainly foreign investors pressing otherwise reluctant firms to pursue strategies of downsizing and asset divestment, or were these investors simply attracted to the kind of firms that had confidence to engage in radical internal restructuring?

Fourthly, the coverage of lifetime employment began to shrink, as temporary and part-time employment grew (see Sako 2006), but the practice of employment stability for core workers continued. The share of wages in national income fell, as elsewhere: in the decade after 1997, dividends rose, cumulatively, by 180 percent but total salaries fell by 10 percent. There was, however, a tendency for employment reductions to be carried out in tandem with dividend cuts: only 2 percent of listed companies taking part in the 2003 METI (Ministry of Economy, Trade and Industry) survey on the corporate system and employment reported cutting jobs but not dividends. Fewer firms engaged in downsizing than in France, Germany, the United States, and Britain in the same period, and downsizing rates fell in the early 2000s. Employment stability was correlated with the presence of insider-dominated boards, but there was no link between lifetime employment practices and foreign ownership (Jackson 2007: 285–9).

This was the context in which the company with committees reform was introduced, in legislation of 2002 which came into force in 2003. In large part thanks to pressure exerted by the principal business association, the Keidanren, the legal changes were only optional, and even when firms

took them up they envisaged a limited role for independent directors, who had to constitute a majority of the board committees for audit, nomination, and remuneration, but not of the main board which retained responsibility for strategic decision making. Nevertheless, the reform clearly envisaged the displacement of the traditional, executive-dominated board, by one in which shareholder interests would in future be more clearly represented and articulated. 2005 saw the hostile bid by Livedoor for Nippon Broadcasting System (NBS), and by extension control of the whole of the Fuji Sankei group, which promised to galvanize the market for corporate control. Although the bid for NBS was not successful, and Livedoor's senior management not long afterward became caught up in an (unrelated) false accounting scandal, it marked increased bid activity in a number of sectors and the arrival of activist hedge funds prepared to use the threat of a hostile bid as a way of refocusing managerial priorities. It also gave rise to an intense legal debate, as courts used the litigation around the Livedoor case to clarify the qualified scope allowed for poison pills and takeover defenses under company law, and the Corporate Value Study Group, a body of experts and representatives of industry and finance established with support from the trade and industry ministry METI and (initially) the Ministry of Justice, set about the task of drafting takeover guidelines. These, among other things, suggested parameters for managers' actions in response to a bid situation and spelled out their duty to show a regard, however qualified, for the interests of shareholders.

The changes to the rules and recommended practices governing external directors and hostile takeovers, while in some respects limited in scope, nevertheless served to import into the Japanese context two pivotal institutions of Anglo-American corporate governance. There is a long tradition in developed economies of nonexecutive directors sitting on the boards of companies. However, the idea that external directors should be independent of management, and should act not simply as advisers on matters of strategy but as monitors of managers in the interests of shareholders, is a relatively recent phenomenon (Gordon 2007, 2008). It began to gain ground in the United States in the 1970s following some high-profile corporate failures, most notably the bankruptcy of the Penn Central railroad, "the bluest of blue chip stocks, as disturbing in its day as Enron's a generation later" (Gordon 2008: 10). It was given legal expression even more recently: the formal requirement that boards of American-listed companies should have a majority of independent directors goes back only as far as the changes made to stock exchange (principally, NYSE and NASDAQ) rules under SEC supervision, following the passage of the

Sarbanes–Oxley Act in 2001. Well before that point, however, most US-listed companies had moved over from the insider-dominated boards of the immediate postwar decades to a structure in which the majority of board members, and in some cases all of them with the exception of the CEO, were independent of the company.

In Britain, the Cadbury Committee's report of 1993 marked the equivalent turning point, although the subsequent Combined Code only contained a recommendation for a majority of independent members on the main board after the Higgs report of 2001. Moreover, the Code's definition of independence largely requires companies to police themselves on this matter, in contrast to the strict definitions which now apply in the American context. Nevertheless, as in the United States, a combination of institutional shareholder pressure, a shift of opinion in favor of the shareholder value norm among senior executives, and the standardizing influence of corporate governance codes and associated legal and regulatory reforms has gradually transformed the composition and function of boards of British-listed companies over the course of the past twenty years (see Armour et al. 2003).

The influence of the hostile takeover in the so-called Anglo-American systems has also been substantial. The hostile takeover is the core mechanism by which, in a "market for corporate control," shareholders can not only bring disciplinary pressures to bear on management, but also, in practice, assert the primacy of their interests over those of other stakeholder groups. Hostile takeover activity moves in cycles, and by no means represents a consistent or continuous pressure on the management of listed companies (Cosh and Hughes 2008). However, successive waves of hostile takeovers since the early 1970s have played a part not just in the restructuring of British and American corporations, but also in helping to shift the views of executives and other corporate governance actors on the issue of whose interests management is meant to serve, with a clear move in favor of the shareholder value norm (Deakin et al. 2003; Jacoby 2005). After the initial impact of the first hostile takeover waves, institutional shareholder influence became the functional equivalent of the hostile bid; from the early 1980s, asset disposals, downsizing, high dividend yields, and share buybacks were increasingly relied on by companies to meet shareholder expectations, whether or not they were the immediate targets of bids (O'Sullivan 2001).

The regulatory changes which occurred alongside the rise of the takeover movement had wider implications for corporate governance practice. In the United States, the case law of the Delaware courts allowed listed

companies to put in place poison-pill type defenses to takeover bids. Boards, with independent directors playing a central role, had some discretion to oppose bids on the grounds of stakeholder concerns, but they were required to have regard to the fundamental principle of safeguarding shareholder interests, in particular, where multiple bidders were involved and change of control became unavoidable. Hostile takeovers were nevertheless seen as an instrument of last resort, and an increasingly expensive one, and were constrained to some degree by legal changes, including pro-stakeholder statutes at state level. The role of the independent board in the 1990s became one of “providing a solution to a core corporate governance problem: how to maximise shareholder value without hostile bids,” which it did by the “benchmarking of management performance to shareholder value through compensation instruments and termination decisions” (Gordon 2008: 15).

In the United Kingdom, the City Code on Mergers and Takeovers went somewhat further in restricting both prebid and postbid defenses, and in focusing the attention of boards on shareholder interests during takeover contests. With few of the legal constraints facing US bidders, hostile takeovers continued to take place on a regular basis, while the shareholder value norm was further reinforced, as in America, by the linking of executive compensation to share price movements and by the dismissal of executives who had underperformed by reference to these criteria (see generally Armour and Skeel 2007, for a comparison of the trajectory of American and British takeover regulation and associated corporate governance changes in this period).

The transplantation of these characteristically Anglo-American institutions into the Japanese context was expected to lead to a significant realignment of Japanese managerial practice. An amalgam of Anglo-American practices and norms drawn from global standards was used as a benchmark for the Japanese reforms. While the changes implied by this approach might not have been intended to bring about a straightforward replication of the American or British models, they were designed to enhance the effectiveness of Japanese corporate governance, on the assumption that the Anglo-American approach represented a model which was better capable of holding management to account and ensuring the efficient allocation of economic resources in response to capital-market pressures (see Ahmadjian 2003). In the early 2000s, the large, insider-dominated boards of the traditional Japanese firm were seen as slowing down decision making and protecting senior executives from appropriate scrutiny, in particular, given the declining influence of the banks in the

aftermath of the bubble. More generally, there was a view that a much-needed restructuring of large Japanese corporations was being delayed by the absence of capital-market pressures of the kind which American and British companies were accustomed to facing. As we have already suggested, the outcome has been somewhat at odds with these expectations. Why is this, and what, more precisely, has been the nature of the changes which have occurred since the early 2000s?

### **The Paradoxical Transformation of Japanese Corporate Governance: Factors at Work in the 2000s**

In Chapter 2, John Buchanan and Simon Deakin present an empirical analysis of the implementation of the company with committees law and related changes to the legal framework governing publicly listed companies. Their work takes the form of a longitudinal case study of twenty companies, beginning in late 2003 and ending in January 2008. Most of the companies were visited at least twice, with extended interviews with senior managers taking place on each occasion. Over fifty such interviews were carried out, covering a range of manufacturing, services, and financial sectors. In addition, over forty interviews were conducted with investors (including insurers, pension funds, and hedge funds), civil servants, experts, and policy makers. The chapter traces the origins of the 2002 law in terms of the criticism of “traditional” corporate governance practices which was mounted around the turn of the millennium, and discusses the significance of the adoption by Sony in the late 1990s of a corporate executive officer system with independent directors on a slimmed-down board, which effectively provided a working model for the 2002 law. They trace the extent of take-up of the new law after it was brought into effect in April 2003, noting that while some prominent companies have adopted the company with committees option, the 110 companies which had opted in by July 2008 represented only 4.6 percent of the first and second sections and Mothers market of the Tokyo Stock Exchange.

Their interview data reveal a picture of the law’s impact which suggests that while its direct effects have been less far-reaching than the proponents of reform might have hoped, its indirect influence on the listed company sector as a whole has been considerable. In companies with committees, they find that, notwithstanding the formal change in corporate structure which followed from the decision to opt into the law, there

was little alteration in the roles played by directors: most boards continued to have a significant executive presence, beyond the CEO, and external directors were treated as advisers and associates, very much as before, rather than as monitors of management or as agents of the shareholders. This could have been because of the limited reach of the law. After all, it was only optional, and, in some ways, not very far-reaching. It did not mandate a majority of independent directors on the main board and its definition of “independence” was loose, enabling corporate groups to place directors from the parent company on the boards of subsidiaries and vice versa, for example. If the intention of the law had been to enable companies which wished to prioritize shareholder value to signal their intention to do so, it was remarkably deficient in meeting this goal (Gilson and Milhaupt 2005).

However, the experience of firms opting into the company with committees structure is only half the story. As Buchanan and Deakin explain, there was a striking continuity between their implementation of the law, and the practice in companies not adopting the committee structure. Although not legally required to do so, many of the latter had increased the representation of external directors and had introduced variants of the corporate executive officer system, in which there is a clearer separation than before between board members and senior executives below the board, and hence between monitoring and execution. Companies of both varieties had used the advent of the corporate executive officer concept to streamline managerial decision making and to put in place more formal internal audit systems, with a prominent role for the board in overseeing internal risk management processes. Thus Buchanan and Deakin argue that while the law has not, a few companies aside, brought about convergence of practice on the Anglo-American model, it has served as a catalyst - or accelerator - for changes in management style and organizational structure which have affected the listed company sector as a whole. Because, in most of the companies concerned, the core of the “community firm” remains intact, not least the commitment to lifetime (or stable) employment, they interpret these developments as a renewal of the postwar model, stressing elements of continuity while acknowledging the model’s adaptability in the face of external pressures. At the same time, growing shareholder pressure in a number of contexts, including hostile takeover bids and hedge fund activism, makes some form of accommodation between the organizational priorities of the community firm and shareholder interests highly likely. It is against this background that a new Corporate Governance Study Group, set up by METI in

December 2008, has been given the task of re-examining the company with committees law. Among other things, the Group will consider whether there is a case for making mandatory legal provision for external directors in listed or other companies, with a view to better protecting the interests of shareholders. Thus the policy debate is by no means settled in favor of the current framework.

The evidence from the study by Buchanan and Deakin complements and updates the more quantitative study of the impact of corporate governance reforms carried out by Aoki, Jackson, and Miyajima in the early 2000s (see Aoki 2007; Miyajima 2007; Aoki and Jackson 2008). On the basis of a survey of listed firms which was carried out in December 2002 and the use of a synthetic index to create a “corporate governance score” for each of the respondent companies, they found a strong relationship between corporate governance and firm performance only for those indicators which related to the level of information disclosure by firms. There was no governance–performance link in the case of board structure changes or the introduction of a corporate executive officer category (their data refer to firms which made this move in the period before the 2002 law came into effect). In companies coming under capital-market pressure by virtue of the presence of foreign and/or more liquid shareholdings, they found that a higher degree of employee participation was more likely, not less, to be correlated with governance reform. Governance changes were less likely in firms with a commitment to lifetime employment and seniority pay, and more likely in firms with limited-term employment and ability-based pay; but they also found that “hybrid” firms with long-term employment and ability-based pay were open to corporate governance reform. This is a theme – the possible emergence of hybrid models which combine external monitoring by shareholders with a continuing commitment to the organizational values of the community firm – to which we shall return.

In Chapter 3 in this book, Masaru Hayakawa and Hugh Whittaker focus on the other major legal reforms which took place in the 2000s, those relating to takeover bids. They provide a detailed account of the legal background to the recent increase in hostile takeover bid activity. They show how takeover bids, while formally possible within the framework of company law, were restrained in practice by cross-shareholdings and corporate group structures in the immediate postwar decades, in some cases as a result of conscious corporate planning and with the encouragement or at least tacit consent of government ministries. In the early 2000s the securities laws were amended so as to formalize the conditions for tender

offers (publicly disclosed bids for control of listed companies). In the Livedoor case, these rules were avoided, along with regulations governing the disclosure of large stakes, with the company taking advantage of the Tokyo Stock Exchange's after hours trading system to acquire over 30 percent of the share capital of NBS without mounting a public bid. When NBS responded by attempting to issue share warrants to a friendly third party, the courts, in judgments drawing on concepts developed in the Delaware case law, responded with an injunction preventing the move. They held that the board, as the organ of the shareholders, was not entitled to take a step which would have had the effect of radically changing the constitution of the shareholder body, with the primary motive of entrenching the existing management. The Livedoor litigation nevertheless established that defensive action would be permissible, in the context of a bid, in one of four circumstances: where the bidder was a "greenmailer" out to extract cash from the company without any regard for its long-term value; where the bidder planned a "scorched earth" policy of disposing of the company's core assets; where a leveraged buyout was being proposed, replacing equity with debt, and where there was share price manipulation based on asset disposals. In the later Bull-Dog Sauce litigation, which involved a challenge to a dilutive share warrant issue arranged by management in response to a tender offer mounted by an activist hedge fund, Steel Partners, the courts took a more negative view of the bid, deciding that the target company was entitled to defend itself against an "abusive acquirer." This did not prevent Steel Partners from making a substantial return on their investment in Bull-Dog Sauce, as the defense put in place by the target company involved compensating Steel for the dilution of their stake brought about by the issuing of warrants to friendly parties.

Following amendments to the law in 2005, large numbers of listed companies put in place poison-pill type defenses of the kind which had succeeded in preserving the independence of the target company in the Bull-Dog Sauce case. There is a contrast between the Japanese stance on poison pills, which are generally intended to be a genuine deterrent to bidders, and US practice, in which, it can be argued, poison pills more clearly serve shareholder interests, even if they lead to the break-up of the firm at the expense of other stakeholders, let alone the much more bidder-friendly regime under the UK's Takeover Code. This difference is reflected in the development of a discourse around "corporate value" in the judgments of the courts and the guidelines being considered by the Corporate Value Study Group. "Corporate value" appears to be an alternative to the

Anglo-American concept of “shareholder value” which stresses the importance of the organizational continuity of the firm in the face of opportunistic bids. However, Hayakawa and Whittaker point out that, since the Bull-Dog Sauce litigation, the Corporate Value Study Group has expressed its support for shareholder empowerment in the context of takeover bids, while the newly established Corporate Governance Study Group has been considering whether to recommend the adoption of a Takeover Panel or similar mechanism along UK lines. Although Japan has not aligned itself with the shareholder value norm, Hayakawa and Whittaker conclude that there is probably no going back to the pre-Livedoor days of shareholder passivity.

These two chapters (2 and 3), then, present something of the uncertainties and ambiguities surrounding key legal reforms of the 2000s. The subsequent chapters serve to explain why their effects have not been more clear cut, by looking in detail at contextual factors at play in the wider corporate governance environment: the role of institutional investors (Chapter 4), the part played by the principal employers’ organizations and trade associations in the debate over corporate governance (Chapter 6), the attitudes of civil servants (Chapter 5) and senior executives (Chapter 7) towards the shareholder value norm, the possible growing role for employee voice within corporate governance (Chapter 8), and the use by management of corporate governance reform as a catalyst for streamlining decision making (Chapter 9). Chapter 10 offers an assessment of the findings of the book as a whole, in the context of the “varieties of capitalism” and of the recent financial crisis.

Sanford Jacoby’s chapter is a study of the activities of the Californian state pension fund CalPERS in Japan. Drawing on extensive interviews with pension fund trustees and managers and corporate governance practitioners in America and Japan, he shows how, starting in the 1990s, CalPERS attempted to transplant the activist approaches which it had pioneered in the US to the Japanese context. The initial stimulus for activism in the United States in the mid-1980s was the practice of incumbent managers paying off “greenmailers” (the Texaco and Bass Brothers case). This prompted CalPERS officials to found the Council for Institutional Investors with the aim of coordinating the efforts of pension funds and other institutional shareholders. Another incentive was provided by the nature of CalPERS’ holdings: because they held shares in indexed tracker funds, and thereby had a stake in most large listed firms, it made sense for them to try to improve governance standards across the market as a whole. CalPERS accordingly began to press the companies it invested

in for wider disclosure, restrictions on takeover defenses, independent boards, and greater acceptance of shareholder resolutions at annual general meetings. This approach was pursued despite a lack of evidence that activism of this kind led to higher returns.

CalPERS' foreign investments began to grow at around the same time (as regulatory constraints were lifted), rising to almost 25 percent by the early 2000s. It began to use its proxy voting rights in Japan to vote against renewal of internal directors, and plans to expand the size of boards; it also attempted to use its influence to raise dividends. This strategy was largely unsuccessful, for a number of reasons which Jacoby sets out on the basis of a close analysis of the institutional context in which CalPERS was operating. Disclosure was limited by US standards, with companies often not publicizing the details of votes. Dividend payouts fell in the 1990s as part of the aftermath of the bubble. Another tactic adopted by CalPERS was to encourage local partners: CalPERS offered encouragement to the Japan Corporate Governance Forum (JCGF) whose principles of corporate governance appeared in 1997, shortly after which CalPERS produced its own standards. The International Corporate Governance Network, which was established with CalPERS' support in 1995, held a meeting in Tokyo in 2001. However, the meeting was used by Hiroshi Okuda, the then Chairman of Toyota, to argue for the continuing distinctiveness of the Japanese approach. In the course of his speech, which senior CalPERS officials interpreted as highly discouraging for their approach, Okuda asserted that a listed company could not be regarded as simply the property of its shareholders. Failing to find a sufficient number of like-minded fellow activists, CalPERS scaled back its activism from 2002 onwards: there were no new major governance initiatives, although some support was given for local "turnaround funds." What then were the long-term consequences of CalPERS' intervention? CalPERS' limited impact implies, Jacoby suggests, that the view of the Keidanren, expressed in the early days of the fund's Japanese investments, that CalPERS's corporate governance recommendations were sub-optimal in the Japanese context, was basically correct.

Ronald Dore looks at the development of attitudes to shareholder value, focusing on the views of civil servants, both publicly and privately expressed, and the experts and industry representatives who make up the membership of the Corporate Value Study Group. He identifies a sea change in attitudes from the 1980s to the present day, and suggests that Livedoor's takeover bid for NBS played a critical role in breaking down an implicit "code of restraint," paving the way for the arrival of activist hedge funds such as Steel Partners and The Children's Investment Fund (TCI).

There is some recognition, Dore argues, that the organizational strength of the Japanese company is threatened by the growing assertion of shareholder interests, and, in particular, by the hedge funds' access to liquidity and by the possibility of high returns that they hold out to investors. He points to skepticism in high circles concerning the role played by hedge funds in a number of the recent high-profile cases: officials and others have been asking what exactly the hedge funds had brought to the companies they invested in, and whether the conditions under which they were compensated for the dilution of their interests were fair to other shareholders. However, the debate over "corporate value" initiated by the Livedoor judgments and the report of the Corporate Value Study Group illustrates, Dore argues, fundamental uncertainty over what the objectives of the publicly listed corporation should be, in place of the clear priority given to organizational values over financial ones as recently as the late 1980s. He concludes that a "silent shareholder revolution" is taking place: an "unshakable orthodoxy" is in the process of forming, in which, notwithstanding the doubts expressed by civil servants, senior industrialists, and others, takeovers are regarded as essential mechanisms for the discipline of managers, with the stock market functioning above all as a market for corporate control.

Takeshi Inagami looks at the evolution of attitudes to corporate governance reform on the part of senior trade and industry bodies since the early 1990s. He argues that there was no clear road map for the evolution of Japanese corporate governance when it began to move towards the shareholder value norm in the early 1990s. In 1994, when the Enterprise Trends Study Group of the Keizai Doyukai (the Japan Association of Corporate Executives) met to initiate debate on corporate governance, it argued for a greater role for independent directors, a move away from the seniority pay system, and the replacement of the "closed" group structures of the keiretsu with more open, flexible capital-market-based financing. The *11th Enterprise White Paper* and the document *Establishing a New Japanese Corporate Governance* were written with certain historical precedents in mind, in particular, the 1947 Keizai Doyukai document, *A Draft on Democratizing the Corporation*. Although this text had argued against shareholder primacy in favor of a principle of equality in terms of decision making, profit-sharing and ownership between labor and capital, with unions shifting their perspective from guaranteeing workers' interests in opposition to the enterprise to strengthening managerial efficiency from within, it had also stressed openness to certain aspects of western capitalism, and had argued for striking a balance between the interests of capital and those of society. In the same

way, the members of the Keizai Doyukai study group saw corporate governance reform at the end of the twentieth century as a means of modernizing Japanese management, while retaining its distinctive essence. The measures they proposed were triggered not by external shareholder pressure but were internally generated from within the discourses of senior management, as a response to what they saw as the crisis then facing the Japanese model.

The year 1994 was also the one in which the JCGF was established. As Inagami explains, the Forum argued that the key questions for corporate governance were: for whom is the firm to be run; and who should make managers accountable? The principles of corporate governance published by the Forum in 1998 argued clearly for the “Americanization” of Japanese corporate governance with shareholders described as residual claimants and the true owners of the enterprise. By contrast, the Keizai Doyukai, at the same time, was stressing the importance of “good corporate citizenship” and the Nikkeiren (the Japan Association of Employers’ Federations) was arguing against “one size fits all.” By 2006,<sup>1</sup> the Nippon Keidanren’s *Interim Statement on Corporate Governance* was referring to the importance of increasing the long-term value of the corporation, arguing against the relevance of universal models of governance, and describing the listed company as a “public institution.” Inagami argues that there has been considerable continuity in the views of senior executives from the first documents of the 1990s up to the more recent *Interim Statement* of the Keidanren. There has been no conversion to American-style corporate governance, not simply because of the fallout from the Enron and Worldcom scandals in the early 2000s or because of the reaction to the Livedoor case but because, more fundamentally, Japan’s community firms have not collapsed, contradicting predictions of their demise. Employees and senior managers have moved to more formal and institutionalized cooperation, he suggests, recognizing that the underlying objective of the community firm is to maintain a viable business.

George Olcott reports the results of interviews with senior managers of large Japanese companies that he and Ronald Dore carried out in 2007 and 2008. Those interviewed include ten current presidents, ten chairmen who are former presidents of companies, and four former chairmen; three generations of corporate leaders are included in the sample, ranging from former executives now in their 80s who were executives in the late 1970s to current executives who are now in their 40s. The interviews focused on five topics: the role of the CEO, the impact of share price movements on

<sup>1</sup> The Keidanren and Nikkeiren merged in 2002.

corporate decision making, board structure, executive pay, and the question of to whom the company belongs. Olcott argues, on the basis of these interviews, that communitarianism, as a guiding ethic for executives, is far from having been delegitimized. There is still a “managerialist paradigm” in place. Recent changes include a greater role for the CEO, and less of a collegial approach to management. There is more direct communication with shareholders than there used to be. However, the interviewees played down the significance of the Bull-Dog Sauce case, with the company and its reaction to Steel Partners being seen as atypical of the wider corporate sector. There is, the interviews reveal, greater sensitivity to share price, but railway and utility companies, for example, continue to stress regularity of supply to customers as the main priority; and currently such companies are relatively immune to takeover. It is accepted that dividend payouts are not going to be as stable as in the past. There is a growing role for outside directors but they tend to be seen as advisers, not the representatives of the shareholders. On executive pay, there is a perception that the gap between the pay of senior managers and the rest had not become excessive. Finally, the idea that shareholders “own” the company has very little support among the senior executives interviewed by Olcott and Dore.

Takashi Araki provides a comprehensive overview of recent developments in the labor law and employment relations areas as they relate to corporate governance. He charts the rise that has taken place in the number of atypical or flexible employees, and demonstrates the link between this trend and corporate governance changes including the decline in cross-shareholdings and the growing role for external directors on boards. However, he argues that the job security of lifetime employees in the “core” has not been much affected by these changes. Notwithstanding some deregulation, including laws loosening controls on agency labor, the legal standards governing dismissal are tight and were clarified in the 2000s; the 2003 changes to the Labour Standards Act put the idea of the nullification of “abusive dismissal” into statutory form. Yet, Araki shows how labor law doctrine also supports the idea of internal consensus and flexibility in the performance of the employment relationship. Thus while the place and type of work must be set out in the employment contract, these do not form contract terms that cannot be altered without the individual employee’s consent or, where relevant, through collective bargaining (as they do, for example, in UK labor law). The employer can change the place of work and the tasks to be performed, with minimal review by the courts. The Supreme Court had held in the 1960s that “unfavorable” modifications to terms and conditions can be made binding on all employees as long as they are

“reasonable.” Thus the employer can make unilateral changes. In 2007, this principle received statutory backing. Although union membership has declined, voluntary joint consultation, which goes back to the productivity movement of the 1950s, remains strong, and valued by both managers and employees. Araki charts recent statutory initiatives which provide institutional support for more formal labor-management joint committees. Referring to the concept of “countervailing power” he concludes that the changes to labor law have acted as a brake on the move toward shareholder value in company law and corporate governance.

Finally, Hisayoshi Fuwa, the CEO of a company in the Toshiba group and a former corporate vice president at the Toshiba parent company with responsibilities including strategic planning and corporate governance structures, describes the process which accompanied Toshiba’s adoption of the company with committees option, and its implications for organizational structures at the company. He shows how Toshiba’s corporate governance changes were linked to innovation in management structures. The shift to a managing officer system began in the late 1990s, but the 2002 legislation was important to the company, as it brought about a clearer demarcation between the board and the senior tiers of managers; previously, senior managing officers would have been expected to reach the board, and execution and monitoring were combined at board level. After the shift to the company with committees structure, there was a clearer demarcation between these two functions. This allowed for a clearer focus on the part of senior executives, and more streamlined decision making. The board, in turn, assumed a more explicit supervisory role in relation to strategic decision making in both the short and long run. In addition to taking a long-term view of strategic matters, it was able to act quickly when short-run strategic decisions were necessary such as those involving mergers and acquisitions. Internal controls were also strengthened along with risk-compliance systems below board level. Thus, corporate governance in Toshiba has evolved in response to the modernization of the company’s managerial structures; the adoption of the company with committees system was just one part of this. Fuwa’s account is a striking illustration of a particularly Japanese conception of corporate governance, which is nevertheless one that may have a wider resonance; as he puts it:

What Toshiba’s experience shows is that corporate governance is about much more than just the behaviour of the board of directors. If it is to be effective, it needs to have a comprehensive approach that covers all considerations of board structure, the supervisory role of the board, management systems and execution, internal controls, attention to stakeholders, and CSR. Moreover, it must penetrate the

thinking of the entire company, at all levels. It is often said that good corporate governance does not translate automatically into good performance. Toshiba feels that it should, and is trying to ensure that it does, by combining its principles of governance with management systems innovation, leading to improved quality of execution by empowered managers under the supervision of the board.

### A Different Path?

The chapters in this book have provided new evidence on the trajectory of Japanese corporate governance which reflects the distinctiveness of the Japanese case, but also illustrates that the system has been changing. Japan's response to globalizing pressures has been highly path-dependent in the sense of being shaped not simply by historical forces in general, but more specifically by the particular configuration of complementary institutions and practices which grew up in the postwar period. But while the system's reaction could be described as one of resistance to external change, we think that it is better characterized as one of adjustment and adaptation to a changing institutional environment, with legal reforms acting as a trigger or stimulus. Another stimulus is the changing competitive environment. The path of Japanese corporate governance has been altered, if not necessarily in the direction expected by the reformers. What lessons can we draw from this process?

One relates to the nature of the so-called global template of corporate governance. The recent Japanese experience has highlighted the considerable extent to which this supposed universal model is a product of the particular context and background of the American and British systems from which it has been distilled. These systems, notwithstanding their differences (see Armour and Skeel 2007), nevertheless share certain core features including dispersed share ownership, liquid capital markets, a prominent role for institutional investors (in particular in Britain), and a relatively weak role for employee voice in the firm (in particular in the United States). Very few other countries in the world, even in systems with a common law origin, possess all these features. The considerable degree of formal convergence of corporate governance systems over the past decade represents alignment on institutional features which are specific to the British and American systems, with laws and self-regulatory codes on board structure and hostile takeover bids leading the way (Armour et al. 2008). However, it is becoming clear that the functional alignment of systems is much more limited than convergence

of form. Corporate governance and comparative law scholars have tended to stress the sense in which formal differences between the laws of national systems masked a deeper, underlying functional continuity across market-based systems (Gilson 2001). The evidence reported in this book shows that the formal convergence of the past decade has coexisted with significant functional discontinuities (see, to the same effect, Shishido 2007). Institutional mechanisms, in the form of independent boards and bid-friendly takeover regulations, which originated in systems where dispersed shareholder ownership and liquid capital markets were the norm, have not worked as expected or intended in a context where those conditions are, still, largely absent. Above all, they have not brought about the fundamental change in managerial practice and behavior toward the shareholder value norm that the proponents of reform were hoping for.

But there is, as we have suggested, a further lesson from the recent Japanese experience, which is that transplants are rarely without effects of any kind. The metaphor of the “irritant” or “catalyst” may be a more appropriate one than the image of the system rejecting the transplant in its entirety (Teubner 2001). In the Japanese case, there have been three broad consequences of the institutional reforms of the 2000s.

Firstly, there has been a strengthening of the community firm in terms of the effectiveness of its managerial procedures (see Chapters 2, 7, and 9). The slimming down of boards and the introduction of corporate officer systems were the catalyst for a shift from the collegiate style of management which had come to prevail in the postwar period, to one in which there was a clearer demarcation between oversight and execution, and an enhanced role for internal audit and formal risk management. In the firms interviewed for the studies reported here, this was seen as a positive development which was likely to enhance the effectiveness of longer-term strategic decision making, although the risks in moving away from peer-based monitoring among senior executives were also recognized. A more formal role for employee voice within the firm (as described by Araki) is being put forward as a counterweight to the concentration of power in the hands of an ever smaller number of very senior executives, although it is not clear how far this movement will go.

The predominant theme running through these developments, notably, has been the role of managers in shaping corporate governance reform. The values and interests of the senior managers who are at the apex of the community firm system were a decisive influence during the process of reform itself. The Keizai Doyukai and other representative bodies

articulated a conception of corporate governance which, despite some vacillation, remained faithful to the organizational goals of the community firm. The Keidanren's intervention, in turn, was important in ensuring that the company with committees law was only optional. In the period following the Livedoor bid, the publicly expressed views of senior managers helped bring about a situation in which hostile takeovers, although no longer seen as impractical, were nevertheless still viewed as exceptional, thereby helping to create the context in which the legal and regulatory system continued to allow listed companies considerable leeway in putting in place defenses to hostile bids. Our case studies show that the managerial shaping of corporate governance continued at the implementation stage, as the governance reforms were used to put into effect a wider strategy for the renewal and modernization of decision-making processes in large firms.

The second change has been, notwithstanding the continuing influence of managerial interests and values, the enhancement of shareholder power. Despite setbacks for shareholder activism, on the part of both pension funds (see Chapter 4) and hedge funds (see Chapter 2), it seems unlikely that, in the aftermath of the takeover battles of the past three years, shareholders will be as passive in the future as they have been in the past. A greater degree of influence for shareholders over managerial decision making, and a growing assertiveness on the part of domestic pension funds and insurance companies, can be expected. This trend may well be encouraged in the immediate term by the deliberations of the Corporate Value Study Group, as Hayakawa and Whittaker make clear.

Can these two tendencies – continuing managerial control, but coupled with growing shareholder influence – be reconciled? A third major change which emerges from our findings is the appearance of new forms of corporate governance which are hybrids in the sense of combining institutional mechanisms with different origins and/or functions. These emergent forms combine elements of relational governance and an internal orientation to management, with a growing role for external monitoring by capital markets. When judged against the practices which grew up around the postwar mode, such a combination appears inherently unstable: will growing shareholder pressure not inevitably undermine the compromises on which the community firm has been constructed? A governance structure which allows the board to mediate between the different stakeholder groups, rather than seeing itself as the representative of shareholder interests, is arguably not just functional but essential for organizations which depend on the long-term value created by firm-specific physical and human assets. This would be threatened, in the

longer run at any rate, by growing reliance on independent directors. Similarly, takeover bids, insofar as they lead to restructurings, asset disposals, and greenmail-type payments as a way of hostile third parties, would disproportionately benefit the present shareholders at the expense of the longer-term interests of employees and other stakeholders in maintaining the organizational unity of the firm. How can a growing role for shareholder voice within corporate governance, together with the use of the capital market as a mechanism of resource allocation, be rendered compatible with the organizational practice of the community firm?

One way in which this might be done is through the “countervailing power” of labor law regulations in placing a limit on the pursuit of shareholder value (see Chapter 8). In this respect, there are similarities between the Japanese developments that we report here, and the practice of “negotiated shareholder value” in Germany, France, and, in certain more regulated sectors of the economy, Britain, involving rent sharing between long-term shareholders and core employees (Vitols 2004; Jackson et al. 2005; Conway et al. 2008).

The same trend may be furthered by developments in corporate governance which assist the processes by which the capital market monitors and evaluates the “internal linkages” between labor and management which are, potentially, the source of long-term value for the firm (Aoki 2007; Aoki and Jackson 2008), although some observers see them as giving rise, less positively, to “stakeholder tunnelling,” or the diversion of rents away from investors (Gilson and Milhaupt 2005). Such developments include the emergence of accounting standards aimed at enhancing the disclosure by firms of the details of how they manage relations with stakeholders, and of how they deal with long-term risks of a reputational and competitive kind. The corporate social responsibility movement is part of this process, and this is arguably playing a role in shifting attitudes of both investors and managers in Japan (see Inagami in this volume), as it has in the European context, although less so in the United States (Deakin and Whittaker 2007). But while, in this context, stock markets may be well placed “to predict future outcomes by aggregating dispersed information, expectations and values prevailing in the economy if they can filter noises to a reasonable degree,” it remains the case that “the last condition . . . is a long way from yet being taken for granted” (Aoki 2007: 444).

The emergence of hybrid forms in a number of different national contexts suggests the possibility of a paradigm shift in the theory and practice of corporate governance, as the pursuit of shareholder value along Anglo-American lines ceases to be seen as synonymous with the modernization

of governance mechanisms. Yet it remains to be seen how viable such hybrid forms prove to be in charting a new pathway for corporate governance, both in Japan and elsewhere. As Japanese corporations enter a new period of uncertainty, in the aftermath of the global financial crisis of September 2008, the effectiveness of the changes made against the backgrounds of the governance reforms of the mid-2000s will be tested in a new and unexpectedly demanding environment. We return to this theme, and some implications of the global financial crisis for corporate governance and varieties of capitalism, in Chapter 10.

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