THE INTERACTION BETWEEN JAPANESE CORPORATE GOVERNANCE AND RELATIONAL CONTRACT PRACTICE

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INTRODUCTION

Until recently, scholars have paid much attention to comparative analysis of corporate governance, focusing particularly on one aspect: Will different corporate governance systems converge, and if so, how? Two rival convergence models currently exist. The first is the "strong convergence model," which predicts that competition will force convergence, because different governance systems are compelled to compete with each other, and consequently the most efficient form will survive out of the competition.[1] This first position emphasizes that efficiency ultimately determines the structures of corporate governance, and predicts that the globalization of the world's economy will compel major firms to adopt the most efficient corporate structure.[2] The other position, the "path dependency model," predicts that institutions evolve along unique paths shaped by their initial starting points and preexisting conditions.[3] Under this theory, different corporate

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[1] *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law,* 89 GEO. L.J. 439 (2001) (discussing that corporate governance will be converged into the American standard of corporate governance, which establishes a strong corporate management with duties to serve the interests of shareholders alone, as well as strong minority shareholder protections, by out-competing alternative models).

[2] *See id.*

[3] *See, e.g.*, Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance,* 52 STAN. L. REV. 127 (1999) (discussing how corporate structures in advanced economies evolve path dependent routes); Mark J. Roe, *Political Preconditions to Separating Ownership from Corporate Control,* 53 STAN. L. REV. 539 (2000) (arguing that a political precondition to the rise of American-style business organization is the historical absence of a strong social democracy). In the midst of the two positions of the strong convergence and the path dependent convergence stands the functional convergence hypothesis. *See, e.g.*, John C. Coffee, Jr., *The Future As History: The Prospects for Global Convergence in Corporate Governance and Its Sig-*

structures have different paths, and a corporation's structure at any point in time depends on the structures it adopted in the past.[4]

Japanese corporate governance has been one of the main targets of these comparative assessments.[5] Traditionally, scholars have focused on the role of banks and stock markets in Japan as compared to the role those institutions play in the United States. One primary difference is that firms in the United States have dispersed shareholder structures in which banks have little role, whereas Japan and Germany adopt bank-centered concentrated ownership systems. It is important to note, in this respect, that Japanese corporate governance originated during the reconstruction after World War II, at which time Japan imported core business norms, including corporate, anti-trust, and securities laws, from the United States.[6] The Japanese corporate structure in pre-World War II

nificance, 93 Nw. U. L. Rev. 641 (1999) (arguing that functional convergence attains, first, through the migration of foreign issuers to the U.S. securities markets and, second, through international harmonization of securities regulation and disclosure standards.); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control,* 111 Yale L.J. 1 (2001) (arguing that functional convergence, the principal mechanism of which is private self-regulation, will dominate formal convergence, and the decentralized character of common law legal systems encourage self-regulatory initiatives, and legal reforms are thus likely to follow, rather than precede, market changes); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function,* 49 Am. J. Comp. L. 329 (2001) (arguing that interplay of functional adaptivity and path dependency will determine the way of corporate governance convergence, and thus there can be no general prediction of the mode that a governance institution will take).

[4] *See* Bebchuk & Roe, *supra* note 3.

[5] Japanese corporate governance has developed its own unique characteristics, by which the basic structure of its governance has deviated from the American model of corporate governance. Milhaupt describes four central norms of Japanese Corporate Governance: (i) the main bank system, in which main banks are a sole delegated monitor; (ii) legal and structural impediments to hostile takeover; (iii) the structure and role of Japanese boards – being a member of boards as a reward for the "crowning achievement in a long career with the firm"; (iv) and the lifetime employment system. Curtis J. Milhaupt, *The Evolution of Nonlegal Rules in Japanese Corporate Governance,* 149 U. Pa. L. Rev. 2083, 2087-95 (2001).

[6] Japanese corporate governance norms are a postwar Japanese invention. The basic statutory framework for Japanese corporate governance is of almost wholly imported origin. Originally, Japanese corporate laws were transplanted from the German model, but amended from time to time in

was not as bank-centered as it currently is, and firms heavily relied on equity financing rather than bank financing.[7] In a sense, the Japanese governance structure has diverged from, rather than converged into, the American standard. It is a mystery why the Japanese corporate structure paved its own way, considering that many of its business law norms were heavily influenced by and transplanted from the United States.

From the perspective of comparative corporate governance, therefore, it is worth examining (i) what initial preconditions influenced the path dependent evolution of the Japanese corporate structure in the post-World War II period, (ii) whether Japanese corporate governance will converge with the US model in the near future, and (iii) if so, what are the pre-

the postwar period under the influence of the American model of corporate governance. *Id.*

[7] *See id.* at 2095-96 (discussing that prewar Japanese corporate governance shared more traits with the present Anglo-American system than with its postwar reincarnation). Milhaupt observes:

> "[T]he main bank system did not exist in the first major phase of modern Japanese economic growth, the Meiji and Taisho periods (1868-1925), nor did any system of bank-oriented corporate governance. Crucially, the government's implicit insurance against bank failure, which animates the main bank norms, was not in place before World War II. At least in the 1920s and 1930s, the Japanese government did not interfere with market discipline on banks, and bank failures were numerous. Mergers and acquisitions were also common in the Meiji Period. The family-controlled conglomerates known as zaibatsu frequently used acquisitions, including hostile takeover bids, as a strategic means of entering and developing industries. Moreover, in the 1950s, several former zaibatsu firms were threatened by hostile bids. Managerial fear of hostile bids may have been an impetus for the practice of cross-shareholding, which emerged about this time . . . [P]rewar practices at the board and employee levels also differed from [those in the postwar period] . . . For example, there is evidence that during the turn of the last century outside directors served on many boards and played an important role in monitoring firms. Perhaps most surprisingly, employment relations through World War II are best described as insecure, as high rates of turnover and a mutual lack of long-term commitment on the part of employers and employees predominated."

See also Yoshiro Miwa & J. Mark Ramseyer, *Banks and Economic Growth: Implications from Japanese History*, 45 J.L. & ECON. 127, 158 (2002) (arguing that prewar Japanese corporate finance did not rely on relationship banking, and instead, firms overwhelmingly raised funds through decentralized, competitive capital markets).

conditions to such convergence. Scholars have contributed much effort to exploring why the Japanese corporate governance structure is as it is today. Gilson and Roe argue that Japanese corporate governance is an efficient response to weakness in the Japanese legal system, and that the unique structures of Japanese corporate governance such as the *keiretsu* system[8] and main bank monitoring[9] have retarded the effective use of contracts.[10] Gilson and Roe also suggest that the Japanese lifetime employment system is a product of political deals in which, as a means of compensating for their dismissal of large blocks of employees, large firms guaranteed lifetime employment for the surviving employees.[11] While the weakness of Japanese law has been emphasized, some argue that it is nonetheless effec-

[8] The stable inter-corporate shareholding structure of the *keiretsu* system is considered one of the unique features of Japanese corporate governance. Inter-corporate shareholding has given rise to a group of shareholders called a *keiretsu,* which is historically derived from a group of affiliated firms that typically own shares in each of the other constituent firms. Indeed, the transitional shareholding structure of Japanese firms from 1949 to 1986 had the following phenomena: (i) the ratio of individual shareholding decreased from 69.1% in 1949 to 23.9% in 1986; (ii) the ratio of shareholding by financial institutions increased from 9.9% in 1949 to 41.7% in 1986; and (iii) the ratio of shareholding by business corporations increased from 5.6% in 1949 to 24.5% in 1986. In short, in the 1980s, almost two thirds of the total shares were held by financial institutions and non-financial corporations. *See* MASAHIKO AOKI, INFORMATION, INCENTIVES, AND BARGAINING IN THE JAPANESE ECONOMY 116-19 (1988).

[9] Traditionally, it has been argued that the main bank system is one of the most important institutional structures of Japanese corporate governance. Firm financing is primarily procured from a main bank, with which it has a long-term relationship. The bank functions as both the largest single lender for the firm and as one of its main shareholders. This relationship has many aspects, including reciprocal shareholdings, the supply of management resources, the dispatch of directors, and various financial services such as loans, operation of payment settlement accounts, foreign exchange services, and any other advisory services relating to M&A or other securities deals. *See* Masahiko Aoki et al., *The Japanese Main Bank System: An Introductory Overview, in* THE JAPANESE MAIN BANK SYSTEM 109-10 (Masahiko Aoki & Hugh Patrick eds., 1994) [hereinafter Aoki, *Introductory Overview*].

[10] *See* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization,* 102 YALE L.J. 871,899 (1993) (discussing cross-ownership structures in Japanese industries as a key element to understand the Japanese corporate system).

[11] *See* Ronald J. Gilson & Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance,* 99 COLUM. L. REV. 508, 524-528 (1999) (explaining how lifetime employment was created).

tive and critically important to Japanese corporate governance and corporate contracts.[12]

Although these arguments suggest an explanation for the historical development of the Japanese corporate structure, this article takes a slightly different view. This article explores the development of Japanese corporate governance by shedding light on the interactive development of corporate governance structure and contract practice. While traditional arguments may have focused on mechanisms of Japanese corporate governance that have made legal enforcement less necessary, they took only a static view of the bilateral interaction of Japanese corporate structure and contract practice. This article attempts to examine the evolution of the interaction between governance and contracting. By examining this evolutionary process, we find that the insufficient infrastructure of business contract practice was one of the primary factors leading Japanese corporate governance to pave its own way. An evolutionary view of the interaction of corporate governance and contract practice also reveals that Japanese corporate governance has functioned primarily as a signal of reputation. Only a firm that adopts a particular corporate structure is able to establish a good reputation, which, in Japan, is the most important self-enforcement device in relational contract practice.

This article is organized as follows. Following this introduction, Part I suggests that the high drafting cost problem inherent in contract practice is one of the primary impediments to the development of discrete contract practice in Japan. Subsection A presents an evolutionary theory of contract practice in business transactions, suggesting that contracts will theoretically evolve from relational to discrete. Subsections B and C suggest that Japanese corporate governance has developed to adjust itself to Japan's unique relational practice which has developed as a result of the high drafting cost problem. Part II details the course of the path dependent development of Japanese corporate structure under the strong influence of relational contract practice. Finally, in Part III, a brief conclusion summarizes the major points of this article.

[12] *See* Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L. L.J. 3, 35-47 (1996) (arguing that formal laws and procedures are increasingly playing a role that was traditionally occupied by the relational theory).

Throughout the discussion in this article, the evidence presented is indirect and suggestive rather than directly probative.

I.
CONTRACT PRACTICE AS A PATH DEPENDENT PRECONDITION TO THE EVOLUTION OF CORPORATE STRUCTURE

A. *Discrete Contracts Dominate Relational*

Firms create relational contracts primarily because unknown contingencies, or the complexity of the required response to anticipated contingencies, prevent the specification of precise performance standards.[13] If contingencies are unknown, firms have no means of responding to such contingencies. Even if contingencies are acknowledged by contracting parties, firms are often unable to write performance standards to cover these situations. The parties will not write special provisions to respond to the contingencies if they are so intricate that the transaction costs involved in writing them do not justify *ex post* legal enforcement.

However, as firms accumulate transaction experience they will learn what contingencies are associated with a particular type of transaction and how these issues should be handled when they materialize. With this knowledge, firms will attempt to reduce these anticipated contingencies to specific terms and conditions in contracts. At this stage, firms may be able to write discrete contracts more cost-efficiently than they could have previously. When firms find that the transaction costs associated with writing discrete performance standards in anticipation of complex contingencies are low enough that legal enforcement might be economically justified, firms are likely to include these discrete standards in their contracts. Even if two firms have already been practicing relational contracting, they will want to reflect their transactional experience in their future contracts. As a result, performance standards for the contingencies are reduced to contract obligations.

[13] *See* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV.1089 (1981) (examining the behavior of contracting parties when the relevant contingencies are too uncertain or too complex to permit the associated risks to be identified, described, and assigned appropriately at the time of contracting).

Consider an economy composed of buyers and sellers. Buyer 1 initiates a transaction with respect to product P_1 at time t_1 by entering into a contract, either relational or discrete. Thereafter, Buyer 2 initiates a transaction for product P_2 at time t_2, Buyer 3 for P_3 at t_3, etc. Assume that each transaction has similar contingencies, and past transactional information soon will be disseminated among all sellers and buyers in the market. Assume also that Buyer 1 is unable to identify a contingency and a required solution to it, and thus chooses a relational contract at time t_1 with respect to his agreement to purchase P_1. By the time Buyer 2 enters an agreement with respect to P_2 (t_2), the past P_1 transaction makes Buyer 2 acknowledge an anticipated contingency that was unknown at t_1. Therefore, in the P_2 transaction, Buyer 2 may want to address a performance standard preparing for such contingency in the contract. Likewise, by the time Buyer 3 enters into the P_3 transaction, he acknowledges even more contingencies. So long as Buyer 3 understands the complexity of the contingencies and has an idea of how to respond efficiently, it should be ready to reduce such complex contingencies into a set of specific performance standards. At t_n, when Buyer *n* wants to enter into an agreement for product P_n, it knows almost all possible contingencies. Since, by this time, Buyer *n* has already learned how to write contracts to respond to the complexity of contingencies in a cost-effective manner, Buyer *n* is able to write discrete contracts. A standard contract model may have been developed by this time.[14] Since older relational contracts are ultimately terminated and newly executed agreements are more likely to be discrete, the regime of discrete contracting dominates the regime of relational contracting by time t_n.

Firms begin negotiations from standard terms as a status quo, and create their own transaction scheme by deleting, amending, and developing those terms. A business commu-

[14] State-supplied standard terms offer advantages over privately-provided terms by reducing the risk of various types of errors caused by defects in forming a contract. However, when a state regulates a contract formulation process, such regulation will result in "a tradeoff between the benefits of reduced error in existing relationship and the costs of failing to exploit fully the potential gains from new relationship." Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 293-94 (1985).

nity gradually accumulates transactional experience and develops skills to cope with anticipated future contingencies. The standard model of contracts gradually becomes thicker and incorporates complicated terms that may efficiently allocate anticipated risks. In a jurisdiction where courts respect such agreements and regularly enforce contract terms, the development of contract practice is a process of creating and developing a new contract standard.[15]

The more complicated the industry, the more discrete contracts are needed to respond to the complexity of contingencies embedded in the transactions. In complex industries, firms must determine whether they want to develop an efficient but intricate transaction scheme using discrete contracts, or whether they would prefer to maintain a simple and conservative traditional transaction model. Firms that seek to expand their business are likely to select the first option unless an institutional barrier exists. In theory, in a jurisdiction where freedom of contract is guaranteed and the infrastructure for making contracts is robust, contract practice ultimately should converge into a discrete regime.

B. *Factors That Impede the Development of Discrete Contracts*

Although economic theory predicts that contract practice in an economically advanced nation evolves from relational to discrete, postwar Japan did not take this path.[16] Some exogenous factors must have existed that impeded the development of discrete terms.[17]

[15] Evolutionary game theory, involving dynamic processes with repeated plays and learning, suggests that a society will choose an efficient contracting regime over time. Even if the discrete regime is too costly at the initial stage, past transactional experience reduces the costs of creating new contract terms. The discrete regime gradually becomes competitive and ultimately wins out. *See generally id.* at 278 (describing how Darwinian competition produces efficient contract formulations).

[16] *See infra* Part II.A.1, B.1, and C.1.

[17] Indeed, evolutionary game theory can lead to many equilibriums depending on the environment in which one resides. *See* Erin A. O'Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151, 1227 (2000) (noting that predictions based on game theory are not very convincing because they can vary greatly depending on the assumptions made).

1. *Courts' Unwillingness to Enforce Contract Terms*

It is widely recognized that the Japanese judicial system prefers to fill gaps between contract terms and transaction substance, and often avoids formal enforcement of contractual terms.[18] Under the gap-filling interpretive regime, provisions that detail each object of exchange are often of no use, and contracting parties are less likely to write discrete contracts. Japanese contract practice has often aimed at *ex post* efficiency, where courts seek an *ex post* fair result rather than the *ex ante* intention of contracting parties.[19] The *ex post* contract adjust-

[18] The law and economics literature argues that there are two approaches in contract interpretation; the formalistic approach and the gap filling approach. *See* Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. U. L. REV. 847(2000) (arguing that formalist modes of interpretation offer the best prospect for maximizing the value of contractual relationships). According to Scott, contract interpretation strategies are generally classified into three categories. The first approach is an *ex ante* efficiency approach, where courts are required to fill gaps objectively, applying default rules that parties similarly situated would plausibly have agreed to at the time the contract was made. *Id.* at 849-50. The second approach is an *ex post* efficiency approach, where courts can seek to direct an *ex post* efficient result rather than attempt to specify default rules that fill gaps *ex ante. Id.* at 850-51. The final interpretive regime, or the formalistic approach, is a strategy where a contract is interpreted strictly in accordance with its language and courts are not asked to fill gaps at all. *Id.* at 851. For an analysis of contract adjustment by courts, see, for example, Robert A. Hillman, *Court Adjustment of Long-Term Contracts: An Analysis under Modern Contract Law*, 1987 DUKE L.J. 1 (1987) (analyzing when court adjustment is appropriate); Clayton P. Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 MINN. L. REV. 521 (1985) (justifying courts' reluctance to *ex post* contract adjustment).

[19] A typical illustration of the gap-filling approach is found in a recent Supreme Court case regarding a lease transaction dispute. *See* 1519 HANREI JIHÔ 69 (Sup. Ct. 1993) (holding that a lease-back transaction, in which a seller sold an asset to a buyer whereupon the buyer leased it back to the seller, was not a mixture of sales and lease transactions as was described in their written contracts, but should be regarded as a loan agreement as a whole). Courts often take a gap filling approach in contract disputes between franchisers and franchisees, where a franchisee seeks to be indemnified by a franchiser against losses arising from the franchiser's business failure. Courts established the doctrine of the duty of care (*hogogimu*). This duty of care obligates the franchiser to disclose to the franchisee an appropriate sales forecast at the *ex ante* contract formation stage, whereupon courts evaluate the appropriateness of the sales forecast at the *ex post* litigation stage. *See, e.g.*, 1516 HANREI JIHÔ 92 (Tokyo Dist. Ct., 1995); 976 HANREI TIMES 182 (Nagoya Dist. Ct., 1998); 1023 HANREI TIMES 203 (Tokyo Dist. Ct.,

ment is supposed to be reflected by the inclination of contracting parties to gravitate towards *ex post* efficiency,[20] but it benefits only relational parties that are bound by relation-specific investments. While *keiretsu* firms may easily create inter-*keiretsu* relational transactions with satisfactory informal dispute resolution mechanisms, non-*keiretsu* firms, whose *ex ante* planning is seriously harmed by courts' *ex post* adjustment, will find it harder to create new transactions. If *ex ante* risk distribution is not an effective tool in their business strategy and they cannot fix anticipated profits and losses before implementing transactions, contracting parties are often reluctant to proceed with new transactions. Firms may otherwise abandon *ex ante* risk distribution, and optimistically expect that third party adjudicators will effectively allocate losses and profits *ex post.*

These negative impacts are limited, however. Courts may want to fill gaps between transaction substance and contract terms (i) if the contract terms are ambiguous or failed to respond to contingencies at the time of contract negotiation, or (ii) if the terms responded to contingencies precisely but it was later found that they deviate from standards of fairness at the time of enforcement.[21] The first scenario is a matter of drafting skills. It may give contracting parties an incentive to

1999). In determining whether the franchiser provided an appropriate sales forecast, courts examine advisory or supervisory activities, actually provided by the franchiser during the term of the franchise contract, such as sales promotion, training, establishment of an operational standard, and advertisement. Courts try to reach a fair result by evaluating not only facts available at a contract formation stage, but total relationship between a franchiser and a franchisee during the entire life of business. *See* Takao Tanase, *Kankeiteki Keiyakuron To Hō Chitsujo Kan [Relational Contracts and Legal Ordering], in* KEIYAKU HŌRI TO KEIYAKU KANKO [CONTRACT NORMS AND CONTRACT PRACTICE] (1999) (suggesting that Japanese transactors often opportunistically seek contract adjustment at the enforcement stage).

[20] Under the relational regime, any unforeseeable events would be resolved, first, through renegotiation, and, second, by a third party adjudicator. It is only in the very last stage that relational parties may want courts to apply the legal norms. In this last legal enforcement stage, contracting parties may expect courts to find out a fair result that they could not reach through their renegotiation process.

[21] *See generally* Goetz & Scott, *supra* note 14, at 267-73 (classifying the typology of contract formulation errors into six categories: (i) administrative error, (ii) ambiguity, (iii) incompleteness, (iv) inconsistency, (v) interpretation error, and (vi) ill-fitting formulations).

write more discrete contracts in future transactions, once they have obtained drafting skills and find that writing discrete terms is cost effective. The second case, an *ex post* adjustment using a general principle of fairness or good faith, might create opportunism, encouraging contracting parties to flee to the relational regime, but contract terms which deviate from social norms are not frequently written into agreements between sophisticated business merchants. As long as two sophisticated players reach an agreement that is not exploitative of one party or the other, courts will not find specific reasons to negate contract terms. Discrete contracts will dominate relational contracts over time, provided the contracting parties are sophisticated business players.

Even though contract terms are routinely disregarded or adjusted by courts, merchants who want to establish rights and obligations in advance, and who also seek formalistic enforcement of their contracts, can rely on alternative dispute resolution (ADR) instead of the court system for interpretation of their contract terms.[22] Additionally, firms can easily escape from an unfavorable home jurisdiction by creating contracts governed by foreign laws and jurisdictions. In fact, it is rather common for Japanese firms to bring their intellectual property dispute cases to U.S. jurisdictions.

2. *Default Rules and Standard Terms*

One may argue that laws or regulations providing a set of default rules or standard contract terms[23] hinder the development of discrete contracts. When mandatory rules provide solutions to anticipated contingencies, courts will invalidate contract terms and instead enforce the mandatory terms. When laws or regulations offer standard terms or default rules that contracting parties have the option to adopt, contracting parties may simply rely on those rules rather than bear the addi-

[22] An industry often creates a private legal system to govern transactions among players in the industry, when they found it advantageous to opt out of the pubic legal system. *See, e.g.*, Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV.1724 (2001) (describing the private legal system in the cotton industry).

[23] For example, the Japanese banking industry published the banking transaction agreement which regulate all transactions between banks and client firms. *See infra* Part II.A.1.

tional transaction costs associated with creating more specific provisions. Default rules reduce contracting parties' drafting costs, but, at the same time, they often become institutional barriers to innovation. Once contract parties are satisfied with default rules, their willingness to use the trial and error method to create tailor made contracts will be reduced. Those who try to create new terms may find it difficult to convince their conservative counterparts to agree to opt out of the default rules. Similarly, once standard contract terms are established in an industry, firms are reluctant to update and modify those terms because they cannot exploit the full benefits of their employees' creativity in contract innovation.[24]

Yet, these negative impacts are limited. Regulations and standardized terms are implemented only when regulators or public lawmakers acknowledge typical contingencies inherent in a particular type of transaction. Most contingencies or problems in an industry will be solved by private parties without acknowledgement by public lawmakers or regulators, and it is therefore unrealistic to assume that most major contingencies are efficiently regulated by the public sector. It is almost impossible for default rules to cover all major contingencies. Furthermore, standard terms often enhance contract negotiation by private parties. Firms can begin contract negotiations by using standard terms as the foundation of a win-win negotiation, and from that point parties can cooperatively develop more specific terms.

3. *Self-enforcing Incentives*

Self-enforcing incentives or nonlegal sanction mechanisms[25] underlying transactions among relational parties often make discrete terms unnecessary. Scholars have observed that contracts in business transactions are neither perfectly contin-

[24] Copyright laws deny property rights in invented contract terms. *See* Goetz & Scott, *supra* note 14, at 292.

[25] Self-enforcement, or nonlegal sanction, is a system in which a breaching party must sacrifice something valuable. *See, e.g.*, Davis Charny, *Nonlegal Sanction in Commercial Relationships*, 104 HARV. L. REV. 375 (1990) (arguing that judicial intervention in private contracts is justified only when transactors mistakenly rely on nonlegal sanction or they are unable to draft enforceable contract terms); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neo-Classical, and Relational Contracts*, 72 NW. U. L. REV. 854, 900-01 (1978).

gent nor relational, and have argued over how incentive devices work in reaction to contingencies not properly addressed in their contracts.[26] Self-enforcing incentives are essential tools for making relational contracts efficient, but they may also coexist with discrete contract terms. Past contract drafting experience reduces the drafting costs of subsequent similar transactions, and opens the door for discrete contract practice. As drafting costs gradually decrease, the benefits of writing discrete terms will ultimately outweigh the costs. Even *keiretsu* firms, which do not need legal enforcement against one another and tend to settle their disputes by self-enforcement, will write detailed contracts for their inter-*keiretsu* transactions if the discrete terms help to enhance their *ex post* renegotiation or other self-enforcement processes.

A stable society makes discrete contracts less necessary, but discrete contracts will never be expelled from real world business transactions. The more advanced an economy is, the more parties want discrete contracts in order to minimize enforcement costs. Even if their self-enforcement device is already robust, contracting parties will try to reduce their self-enforcement costs by using contract provisions as a complement to self-enforcement. A firm that in the past has adopted relational contracting will not necessarily stick to relational contracting in its future transactions. Those firms residing in the regime of a relational practice will start to write discrete contracts once they find that incomplete terms make legal enforcement too costly or that self-enforcement is more costly than legal enforcement. Moreover, although institutions have offered various incentives that enhance self-enforcement, they cannot perfectly support self-enforcement in all business transactions. Indeed, it is unrealistic to assume that main banks have monitored firms perfectly simply by threatening to punish managers in the financial crisis.[27] *Keiretsu* cross-shareholding functions only among *keiretsu* firms, but once transactions begin to occur among different *keiretsu* firms, they should use more discrete contracts.[28]

[26] *See* Goetz & Scott, *supra* note 13, at 1091 (1981) (examining the behavior of contracting parties when the relevant contingencies are deemed too uncertain or too complex to permit the associated risks to be identified).

[27] *See infra* Part II.A.2.

[28] *See infra* Part II.B.2.

4. *The High Drafting Cost Problem*

Institutions that enhance relational practice, such as gap-filling, default rules, standardized terms, and self-enforcing devices, may retard the speed at which contract terms develop, but they cannot stop a general movement to discrete practice. Once transactional experience in an industry reduces future drafting costs, innovative terms gradually will become competitive with old terms and ultimately will dominate them. Accordingly, the long-term dominance of relational contract practice over discrete contract practice occurs if and only if drafting costs remain high despite the accumulation of transactional experience. Postwar Japanese firms had no basic contractual infrastructure to enable them to reduce contingencies to specific contract terms. The weak infrastructure of business law practice has prevented the creation and flow of efficient contract provisions and prevented firms from obtaining familiarity with drafting contracts.[29] Even when they recognize anticipated contingencies and possible solutions, firms are unable to construct provisions addressing them because they lack the experience and skills for effective contract writing. As drafting costs have remained high throughout the postwar period, firms have had little opportunity to turn to a discrete contract regime. The only way to deal with contingencies has been to strengthen bonds or hostages to be exchanged by relational firms.[30]

The history of Japanese lawyers clearly indicates that they have played little role in business transactions throughout the prewar and postwar periods. From the time professional lawyers first appeared in Japan in 1893 after implementation of the Lawyers Law (*bengoshi-hō*), and throughout the prewar period, the legal profession was seen as a field of lower prestige, mainly composed of bachelors with poor academic records.[31]

[29] *See* Goetz & Scott, *supra* note 14, at 292-3 (arguing that the difficulty in coordinating a move to new contractual language often lead to the undersupply of innovative provisions and the lock-in of inefficient contract provisions).

[30] The norm of *hostage* was introduced by Williamson. *See, e.g.*, Oliver E. Williamson, *Credible Commitment: Using Hostages to Support Exchange,* 73 AM. ECON. REV. 519 (1983).

[31] *See, e.g.*, KAHEI ROKUMOTO, HŌ SHAKAIGAKU [THE LAW AND SOCIOLOGY] 292-94 (1986); Richard W. Rabinowitz, *The Historical Development of the Japanese Bar,* 70 HARV. L. REV. 61, 73 (1956); MASAYOSHI KOGA ET AL.,

The Lawyers Law of 1893 prevented autonomy of the Japanese bar by placing it under the control of the procuracy.[32] Prewar Japanese lawyers could not find much work in the business field, because the development of the legal profession was much slower than the development of business practice.[33] The growth of capitalism, backed by government bureaucrats in the late *Meiji* and *Taisho* periods, alternatively required that government officials and major firms employ elite bachelors of law.[34] Major prewar Japanese firms did not use lawyers; instead, firm employees with law degrees handled their legal issues.[35] Professional lawyers' main clients had been smaller firms and individual industrialists in urban areas that could afford to employ law bachelors.[36] The limited resources of those small firms and industrialists prevented them from allocating funds for preventive law or contract negotiation. As a result, the lawyers' primary role was to handle litigations.[37]

Although postwar lawyers have obtained high prestige and autonomy with perfect independence from government institutions, the government's prewar treatment of lawyers subtly influenced the legal profession by confining its mission to human rights advocacy.[38] More importantly, the most negative effect of this postwar trend is that a left-leaning public opinion developed, which presupposed that business law was not part of the area in which lawyers should practice. The bar associations turned their backs on the business field, and firms continued to ask their in-house law bachelors to deal with legal issues. Although Japan has already produced several groups of legal professionals – such as *benrishi* (patent attorneys), *shihō-shoshi* (judicial scriveners: licensed legal professionals who specialize in real estate and corporate registration and drafting of legal documents to be presented to the court), *gyōsei-shoshi* (administrative scriveners: licensed professionals who prepare documents for submission to government and public offices)

BENGOSHI NO GYŌMU, KEIEI [PROFESSION AND MANAGEMENT OF JAPANESE LAWYERS] 45 (1970).

[32] *See* Rabinowitz, *supra* note 31, at 70.

[33] *See* KOGA. ET AL., *supra* note 31, at 45.

[34] *Id.*

[35] *Id.* at 76.

[36] *Id.* at 46.

[37] *Id.*

[38] *See* ROKUMOTO, *supra* note 31, at 294.

and *zeirishi* (certified public tax accountants) – these professionals have not expanded their professional domain to the area of contract negotiation.[39] Contract negotiation has long been considered as lawyers' domain, but lawyers were not interested in it. Furthermore, they could not find positions as in-house counsel because they were not permitted to work for non-lawyers. This prohibition has been lifted, but lawyers must first receive permission from the bar association in order to pursue employment outside of a law firm.[40]

As long as businesses do not require lawyers and lawyers are less interested in business than in other fields, the market for legal services will remain small. Not surprisingly, the number of lawyers in Japan has remained low throughout the postwar period. In 1952, only about 40% of the law faculties graduates took the bar examination, and only 5% of those were successful.[41] Throughout the postwar period, the number of lawyers who passed the bar examination was only about 400 to 500 per year.[42]

Throughout the historical development of the legal profession, contract negotiation was seen as an aspect of business that was beyond the realm of lawyers' expertise and responsibility. Business contracting in Japan has been handled by corporate employees with law degrees, who lack a network for exchanging information about the innovation of contract terms. The non-existence of business law firms has been a structural

[39] *See generally* Michael K. Young & Constance Hamilton, *The Legal Professional of Japan, in* JAPANESE BUSINESS LAW GUIDE (Mitsuo Matsushita ed., 1988).

[40] Daly described that, in some countries, such as Italy, Japan, and India, the doctrine of incompatible professions forbids a lawyer from engaging in a profession or business other than the practice of law. Mark C. Daly, *The Cultural, Ethical, and Legal Challenges in Lawyering for a Global Organization: The Role of the General Counsel,* 46 EMORY L.J. 1057, 1099 (1997). There has been a strong bias that employment of lawyers by firms unrelated to the practice of law will undermine this independence. The Japanese bar association had long prohibited qualified lawyers from being employees of business entities. Recently it has changed its policy and it now permits them to be employees of business entities, but it still requires lengthy procedures. *See* Jason Marin, *Invoking the U.S. Attorney-Client Privilege: Japanese Corporate Quasi-Lawyers Deserve Protection in U.S. Courts Too,* 21 FORDHAM INT'L L.J. 1558, 1567- 69 (1998).

[41] Rabinowitz, *supra* note 31, at 81.

[42] KOGA ET AL., *supra* note 31.

barrier to the development of new contract terms, which has, in turn, seriously retarded the development of discrete practice.[43]

C. *Japanese Corporate Governance: Reaction to the Relational Practice*

Throughout the prewar and postwar periods, the speed with which the legal profession developed could not catch up with the pace of the development of Japanese capitalism. While the growth of capitalism was rapid throughout the postwar period, Japanese contract practice did not evolve. Thus Japan had to develop a unique structure of corporate governance in order for contract practice to catch up with the double-digit economic growth.

In the initial stages of its formation, Japanese corporate governance was influenced by relational contract practice as a response to the high drafting cost problem. In exploring how Japanese corporate governance reacted to the relational practice, it is necessary to examine the development of self-enforcement mechanisms, which function as a key element of relational contract practice. Generally, the development of relational practice is closely linked to the development of self-enforcing mechanisms. A relational regime develops its self-enforcement mechanisms stage by stage. The first stage is a primitive stage of verification, where no specific bonding mechanism is deployed. At the second stage of a relational regime, businesses develop an advanced firm-to-firm coopera-

[43] As Bernstein describes in her cotton industry illustration, an "exogenous shock" is often necessary for businesses to move to the equilibrium of more efficient contract provisions. In the cotton industry, Bernstein observes, new trade rules are introduced into contract models and shared by members of the industry so soon that contract practice continues to evolve constantly. When the industry is locked into an inefficient contract practice, such introduction of new terms in contract models can provide the exogenous shock that moves businesses to the more efficient equilibrium. *See* Bernstein, *supra* note 22, at n.85. Large law firms with an extensive practice in a particular subject area are expected to contribute to the invention and familiarization of contract terms by use of their extensive experience, and at the same time mitigate free rider problems by confining the benefits to their own clients. Absent an infrastructure that enable business lawyers to exchange update information of new trade terms, however, private parties are unable to accumulate drafting models and thus no exogenous shock occurs. *See* Goetz & Scott, *supra* note 14, at 304.

tion in repeat deals, often accompanied by other relation-specific mechanisms of relational bonding, such as the exchange of asset investments. Finally, entities involved in the relational regime come to rely on reputation, which functions as a homogeneous self-enforcement mechanism.[44]

The development of Japanese corporate governance parallels the evolution of relational contract practice. In the first stage, when a market is immature and still developing, contracting parties have very little knowledge about one another. They are compelled to rely on each other's good faith and reciprocity. Presumably, the probability that a firm will act fairly and reciprocally is significantly higher when reciprocity and good faith become important social norms of the community.

When contracting parties find it infeasible to rely on social norms, they may deploy bonding devices as a means of self-enforcement in order to secure their transactions. The literature on the subject traditionally has emphasized that repeated deals and reputation play important roles as self-enforcement devices in corporate contract practice in Japan. It is important to note, in this respect, that cooperative repeat deals and other firm-specific asset exchanges are based on heterogeneous firm-to-firm relationships, whereas reputation is more homogeneous and has developed as an enforcement mechanism only in mature communities where reputational standards and dissemination mechanisms are well established. As their relationships evolve, contracting parties begin to exchange firm-specific investments to strengthen their bonding mechanisms. The accumulation of transaction experience and the development of commercial markets will create an environment where reputation can emerge as a more homogeneous bonding mechanism. As a corporation is a nexus of contracts among various players, corporate structure must react to the requirement of a bonding device to achieve efficient self-enforcement. This article suggests that the Japanese corporate governance structure itself functions as both a reputation signal and a kind of firm-specific asset exchange.

[44] While heterogeneous based self-enforcement only requires a particular asset and a commitment to long term transactions, homogeneous mechanism of reputation requires sufficient accumulation of transaction history and record. Obviously, it takes longer for a market to accumulate a firm's reputational information.

1. *Heterogeneous Verification Process Using Social Norms*

A firm without sufficient bonding devices for self-enforcement must rely on the subjective presumption that its trading partners are fair and reciprocal. A firm will expect social norms emphasizing fairness and reciprocity to sufficiently constrain the opportunism of its counterparts.[45] However, relying solely on this optimistic presumption is no more than a gamble. The possible solutions are (i) to strengthen the social norms of fairness and reciprocity, or (ii) to create new verification mechanisms.

Many Japanese law scholars have focused on Japanese societal and cultural background to argue that Japanese attitudes toward contracts are somehow linked to the origins of Japanese society. The scholars posit that Japanese contracts reflect the trust and harmony required in a farming culture, in contrast to the aggressive, pioneer spirit of a hunting culture supposedly reflected by the American approach.[46] Takeyoshi Kawashima explained that in Japan, contracting parties do not stipulate in a detailed manner rights and duties under contracts. Typically, the "confer-good-faith" clause, which provides that "the parties shall confer in good faith in the event that a dispute arises between the parties with regard to the rights and duties provided in this contract," is the core of Japanese contracts.[47] Further, Kawashima refers to the traditional Japanese concepts of honor and trust such as "*jōjō* (the surrounding circumstances), *giri* (moral or social obligation to others), *ninjyō* (human feeling), *yūjō* (friendship), and *magokoro* (sincerity)."[48] Even though critics of the Kawashima theory would argue that no one can define precisely the "legal consciousness" of Japan,[49] the fact that Japanese legal litera-

[45] Recent research revealed that different countries have different degrees of fairness and reciprocity. *See* Robert E. Scott, *A Theory of Self-enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1667 (2003).

[46] *See* Daniel H. Foote, *Evolution in the Concept of Contracts, in* UNITED STATES / JAPAN COMMERCIAL LAW AND TRADE, 689, 689 (Valerie Kusuda-Smick, ed., 1990).

[47] Takeyoshi Kawashima, *The Legal Consciousness of the Japanese,* 7 L. JAPAN 1, 17, 18 (1974).

[48] *Id.* at 6-7. For an analysis of Kawashima's theory of Japanese legal consciousness, see, *e.g.*, ROKUMOTO, *supra* note 31.

[49] Tanase observes that "[b]ecause no macro theory, like Kawashima's modernization/time-lag theory, places the chosen cultural element into

ture often emphasizes this "legal consciousness" indirectly proves that Japanese firms have traditionally emphasized social norms of good faith and fairness. Those social norms present a nonlegal sanction mechanism: the non-performing party will be punished on a psychic level by sacrificing self-esteem or self-confidence.[50]

Firms try to find ways to verify their counterparts. Contracting parties, for instance, often exchange legally non-binding letters of intent, or memorandums of understanding, which may function as means of screening business partners.[51] As another example, a firm's manager often hosts a dinner (*settai*) for the firm's potential customer at a high-class Japanese-style restaurant before the parties proceed with contract negotiations. The host hopes to verify the level of reciprocity or fairness of the guest through their conversation during the *settai*. The guest may feel that it must respond to such efforts of the host with a higher degree of reciprocity or fairness. After the *settai*, each party may feel that the other has the appropriate level of reciprocity such that it will satisfy performance expectations or that, even if a dispute arises in the enforcement stage, the parties will be able to solve information asymmetries and reach a fair result.

As relational practice evolves, corporate governance structure must adjust. Throughout the verification process, managers and officers want to transact with those whom they know well. In this context, it is a natural consequence that the traditional prewar *zaibatsu* was reformed as *keiretsu*. For so long as executive officers of *keiretsu* firms are former employees of a *zaibatsu* firm, those firms will transact with each other more frequently because they may be able to verify each other and reach information symmetries more efficiently.

wider theoretical framework, the whole effort is something of an ad hoc process whereby concepts are created to suit the explanation at hand." Takao Tanase, *The Management of Dispute: Automobile Accident Compensation in Japan*, 24 L. & SOC'Y REV. 651, 653-54 (1990) (arguing that the analytical method of Japanese legal consciousness has mainly been anecdotal, and one can always find anecdotes that support his argument).

[50] *See* Charny, *supra* note 25, at 393-94. Cooperative-based commercial systems may be stable when social norms of honor and a basic human desire to think of one's self as trustworthy are powerful motivators of transactional behavior. *See* Bernstein, *supra* note 22, at 1787.

[51] *See* Scott, *supra* note 45, at 1683-84.

2. *Repeated Deals, Verification of Future Managers, and the Stability of Corporate Structures*

In the stage involving firm-specific asset exchanges, cooperative repeat deals play a particularly important role. A self-enforcement mechanism using discipline in repeat deals is classified as a relation-specific exchange of assets, or a hostage.[52] Parties who perform poorly in one spot transaction are punished in future transactions. The asset exchanged is a future deal in the long-term relationship. The discipline of repeat deals, however, does not work efficiently once one deal falls apart and reaches an end game stage. Thus, contracting parties seek an additional bonding mechanism that will support a cooperative relationship and give contracting parties an incentive to hold up their end of the deal. For instance, a manufacturer and its supplier in a vertical *keiretsu* often exchange relation specific investments of technology and an assembly line. The manufacturer gives technology assistance to its supplier and the supplier invests in a new assembly line. As another example, in financial transactions, debtors often provide their creditors with some form of collateral. By posting collateral, the debtor increases his credibility and thus causes the creditor to have more faith in him.[53]

Some argue that Japanese corporate governance often helps to create this kind of relation-specific asset exchange. For instance, *keiretsu* cross-shareholding often functions as a firm-specific hostage. If a *keiretsu* firm breaches, the firm may be expelled from the *keiretsu* group through liquidation of the cross-shareholding. The firm is then exposed to the risk of becoming the target of a hostile takeover.[54]

[52] For the analysis of the mechanism of cooperation in repeated transactions, see, for example, Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005 (1987).

[53] *See, e.g.*, Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 927-29 (1986); *See also* Ichiro Kobayashi, *Private Contracting and Business Models of Electronic Commerce*, 13 U. MIAMI BUS. L. REV. 161, 172-79 (2005) (explaining that for the purpose of relation specific asset exchange as a hostage, an intangible soft asset of information is more suitable to electronic commerce than a hard asset of collateral).

[54] Hostile takeovers played an important role in restructuring corporate entities in the United Stages, but were rarely utilized in Japan, even though Japanese securities law permits takeover bids. Hostile takeovers theoretically have not only the aspect of monitoring management but also that of moni-

When firms are unable to deploy firm-specific asset exchanges to solve the end game dilemma, they must develop other verification tools. It is important to note that a firm must verify the reliability of *future* officers – those who will be in charge if and when an end game situation arises – rather than the current officers now in charge. Suppose there are two types of individuals: a reciprocally fair type and a self-interested type. When firm A enters into repeat transactions with firm B under the relational regime where legal enforcement is almost impossible due to high drafting costs, the primary concern of A is when B will trigger its end game option. For A, the worst scenario is that B opportunistically shirks and terminates the contract with A when B acquires the option of transacting with another party on more favorable terms. The probability that A will have to face B opportunism in the future may depend on whether the future officers of B at the end game stage are reciprocally fair or self-interested. If B's future officers are fair-minded, the risk that B will act opportunistically may be substantially lower, whereas, if the future officers are self-interested, there may be a substantial risk of such opportunism. However, the problem for A is that it cannot predict who will be B's officers at this anticipated future end game stage. A can only verify the reliability of the current officers of B at the time of contract negotiation. One way for A to predict how B's future officers will act is to verify the corporate structure. If the corporate structure of B predicts that the current officers will continue to be in charge of a transaction, or be promoted to higher ranked positions from which they will supervise their successors, A may predict that the degree of B's reciprocity will not change drastically in the future. Conversely, if B's corporate structure clearly predicts frequent change of management policy reflected by liquidity in the shareholding structure and employment, A may encounter a higher probability that B will act opportunistically in the future.

toring the use of free cash flow, but the *keiretsu* system constrained those shareholders' monitoring function. *See* Gilson & Roe, *supra* note 10. There was a firmly established socially negative view toward hostile takeovers in Japan, and hostile takeovers became more costly than the alternatives due to the existence of the *keiretsu* system. Milhaupt, *supra* note 5, at 2090.

The implication of the example above is important. From the perspective of corporate governance, liquidity in ownership means frequent replacement of managers and officers, as well as frequent change of management policy. Firms under a relational contracting regime may seek stability in their shareholding structures, especially when relational contracts rely heavily on long-term officer-to-officer relationships. In this sense, Japanese corporate governance has adjusted to accommodate the social preference for business stability. Indeed, the restructuring of enterprises has been abhorred in Japan. As discussed in Part II, in bank-borrower relationships, main banks often rescued failing firms under an implicit insurance commitment. In inter-firm relationships, both the cross-shareholding structure of the *keiretsu* and the lifetime employment system functioned as indicators of management stability. If the *keiretsu* cross-shareholding sufficiently reduces the probability of hostile takeovers, employer opportunism of appropriating employees' firm-specific investments is prevented, and employees are encouraged to enhance their commitments to firms.[55]

Thus, firms seek to develop social norms that emphasize stability in corporate structures and transaction relationships, and to develop a social structure in which the liquidity of firms, shareholders, managers, and employees is strictly constrained. In a society which values stability, a firm may be deemed reliable when it concentrates on creating long-term relationships with its customers and employees. Under the regime of relational contracts, a firm will have a better reputation if it seeks long-term relationships with particular customers and refrains from dismissing employees regularly. A society wants a firm in which ownership does not change frequently, because such a firm is more likely to have a stable management policy. The degree of a firm's reciprocal fairness is supposed to be stable if its constituents – shareholders, executives, managers, officers, and employees – remain stable.

3. *Japanese Corporate Governance as a Reputation Signal*

At the final reputation stage, a particular firm's governance structure itself constitutes an integral part of its reputa-

[55] Milhaupt, *supra* note 12, at 28.

tion.[56] A firm wants to develop and preserve cooperative relationships in repeated deals. As an efficient relational practice requires a stable society, corporate structures must also be stabilized under a regime of relational contracts. Stability is emphasized in the relational regime because self-enforcing cooperation in repeated deals is premised on the assumption that neither party will pull an end game trigger without reasonable cause. Firms want to transact with other firms that place an emphasis on cooperation in repeat deals. Under the relational regime, one may be reluctant to do business with a firm that may be dissolved or which might terminate the relationship in the very near future due to a change in management policy. Japanese corporate governance was first created as a reaction to the societal demand that firms be stable in their contract relationships and corporate organizations. The governance structure then accelerated firms' exchange of firm-specific bonds, and once these interactions were set in motion, the structure ultimately found its place as a signal of reputation in a homogeneous community.

In a society that seeks social stability, a firm's reputation improves when its corporate structure adopts a *keiretsu* cross-shareholding and lifetime employment. When a firm breaches a contract among *keiretsu* firms, it will be punished by being expelled from the *keiretsu* group. A firm expelled from a *keiretsu* may lose its good reputation. A firm's reputation also may be destroyed when a firm voluntarily liquidates its stockholding in other member *keiretsu* firms because this shrinks the size of the *keiretsu* group. Further, a bank will earn a good reputation if it undertakes an implicit obligation to rescue failing firms. A bank's refusal to rescue a failing firm without

[56] Nonlegal sanctions by using reputation are widely used in business transactions. A community where a discrete contract practice is prevented wants to develop a stronger mechanism of third party adjudication using various aspects of reputation signals. A promisor's poor performance or breach of substantial contract obligations will cause the significant damage of its reputation in a market and the loss of future trade. Reputation functions best when the system of creating and evaluating reputation is established among a community and a reputation signal is soon disseminated among members of the community. For instance, a credit rating system in capital markets is a system using reputation, in which providers of credit rating, such as Moodys and Standard & Poor's, function as reputational intermediaries, and evaluate stocks and debts in capital markets. Their evaluation is sensibly reflected in the price of stocks and debts.

good reason may cause the destruction of the bank's reputation in the financial market.

To sum up, the basic structure of Japanese firms is, in a sense, a reflection of the society's emphasis on the stability of corporate structures. When a firm enters into a long-term transaction, it wants its counterpart to be structurally stable. In this context, it might be expected that firms will attempt to verify the reciprocity of a potential transaction partner by first examining the level of stability of its corporate governance structure. Ultimately, a particular style of corporate governance comes to function as a reputation signal. A firm that adopts a lifetime employment system may be deemed more reliable than one that does not. Concentrated ownership and lifetime employment thus are used as proxies for the stability of the counterpart's management, and such stability presumably minimizes the probability that the counterpart's officers will act opportunistically in the future.

D. *Summary*

The analysis in this Part I leads to the following theoretical suggestions. First, the theory that discrete contracting dominates relational contracting implies that a society will move toward a regime of discrete contracting as long as the infrastructure for business contracting is robust. Nonetheless, Japan has chosen a regime of relational practice rather than a discrete contract practice, in part because of high drafting costs. Second, Japanese corporate governance was first created in reaction to social norms emphasizing stability. It then accelerated firms' exchange of firm-specific bonds, and finally sublimated itself to an integrated part of a firm's reputation insomuch as a firm that adopts a particular corporate governance institution earns a good reputation. This development process parallels the development of a relational regime. A relational regime requires social stability as a precondition. It first develops mechanisms of self-enforcement using a heterogeneous firm-specific sanction, and then develops a homogeneous mechanism of reputation as a bond.

A relational practice is fragile, however. It will not last unless the society is stable. Political pressure to maintain a regime of relational contracting will weaken once a society begins to move toward a discrete regime. In a society where there are many business lawyers, pressure from businesses to develop a discrete contract practice would easily outweigh any pressure to preserve a relational practice. Thus, over time, discrete contracts ultimately dominate relational contracts in business-to-business transactions. Japanese corporate governance would not have maintained its current structure if not for the high drafting cost problem caused by Japan's lack of an adequate business contracting infrastructure.

II. THE DEVELOPMENT OF UNIQUELY JAPANESE CORPORATE GOVERNANCE

Part I of this paper suggested that Japanese corporate structure adjusted to accommodate the social preference for stability in social structures, and the abhorrence of restructuring and change of ownership. This section offers a detailed explanation of how Japanese corporate governance reacted to such requirements. As each institution of Japanese corporate governance functions differently, the discussion is divided into three sections: bank-borrower relationships and the main bank system (subsection A), inter-firm relationships and the *keiretsu* cross-shareholding (subsection B), and employer-employee relationships and lifetime employment (subsection C). Each subsection starts with a detailed analysis of the prevailing contract practice in each relationship, and then discusses the possible reaction of Japanese corporate governance which might have led to that practice.

A. *Bank-borrower Relationships and the Main Bank System*

1. *The Relational Practice in Banking Transactions*

Japanese banking transactions have long used the standard form of the Banking Transaction Agreement (*ginkō torihiki yakujō*), which was drafted and published by the Federation of Japanese Bankers Association (the "Standard Form").[57]

[57] The Standard Form of the Banking Transactions Agreement was a sample agreement applicable to banking transactions in general. The enactment of the Standard Form was motivated by Government v. Mitsubishi Bank (1957), through which banks acknowledged that banking agreements previously used were incomplete for protecting banks' interests. For the detail explanation of the Banking Transactions Agreement, *see e.g.* TAKEO SUZUKI ET AL., GINKŌ TORIHIKI TO YAKKAN, HANREI, RIPPŌ [BANKING TRANSAC-

This Standard Form was widely used until the Japanese Bankers Association (the former Federation of Japanese Bankers Association) abolished the publication in 2000.[58] In fact, until recently, most banks in Japan used the Standard Form in almost all transactions. Research shows that about 99% of Japanese banks were using agreement forms that were substantially the same as the Standard Form.[59]

The first draft of the Standard Form was prepared in 1957, and was officially published on August 7, 1962 after the Association incorporated the holdings of relevant court cases and comments from scholars and other interested parties.[60] The Standard Form was a fundamental agreement outlining the basic understanding of a bank-client relationship. Based on the Standard Form, an individual loan agreement (*shōhitaishaku keiyaku shōsho* or *shōsho kashitsuke yakujōsho*) is exchanged for each loan. This was usually a simple, one- or two-page contract which laid out the loan amount, repayment date, prepayment and other basic conditions of the loan.[61]

When the Standard Form was officially published, not all banks adopted it. At the outset, it was merely a model for the banking transaction agreement, but gradually it diffused and soon almost all banks adopted it.[62] The Standard Form was amended in 1977, in response to strong criticism alleging that banks were abusing their bargaining positions by using provi-

TIONS WITH STANDARD AGREEMENTS, COURT CASES, AND LEGISLATIONS] (1972); THE FEDERATION OF JAPANESE BANKERS ASSOCIATION, SHIN GINKŌ TORIHIKI YAKUJŌSHO HINAGATA NO KAISETSU [A COMMENTARY OF THE NEW MODEL FORM OF THE BANKING TRANSACTION AGREEMENT] 244-51 (1977) [hereinafter YAKUJŌSHO KAISETSU]; SEIJI TANAKA, GINKŌ TORIHIKI HŌ [BANKING TRANSACTION LAWS] (4th ed., 1991).

[58] *See* news release posted in the website of the Japanese Bankers Association, http://www.zenginkyo.or.jp/news/12/newsgintori.html (last visited January 8, 2006).

[59] *See* CORPORATE FINANCE AND TREASURY ASSOCIATION OF JAPAN, GINKŌ TORIHIKI YAKKAN NO ARIKATA NI TSUITE [REQUEST FOR AMENDMENT OF THE BANKING TRANSACTION AGREEMENT], *at* http://www.enkt.org/yobo_06.html (last visited July 17, 2005) [hereinafter YAKKAN NO ARIKATA].

[60] *See, e.g.*, SUZUKI ET AL., *supra* note 57; YAKUJŌSHO KAISETSU, *supra* note 57, 244-51.

[61] In 1963 the Association unofficially published other supplemental model forms, such as the individual loan agreement form and the checking account agreement form. *See* YAKUJŌSHO KAISETSU, *supra* note 57.

[62] *Id.* at 244-51.

sions in the Form that were overly advantageous to them.[63] In 1976, some members of the House of Representatives argued that certain provisions of the Standard Form violated Article 90 of the Civil Law (which prohibits judicial validation of legal acts counter to public policy) on the ground that it was unilaterally and unreasonably advantageous to banks.[64] Some of the Representatives even argued that Sections 5 and 7 of the Standard Form constituted unfair trade practice and thus violated the Anti-Competition Law.[65] Further, in 1976, the Ministry of Finance (the "MOF") adopted an administrative regulation requesting that banks amend the set-off section of the Standard Form.[66] With this controversy in the background, the Association finally amended the Standard Form in 1977, and the amended Form continued to be the standard agreement of all banks until it was abolished in 2000.

The brunt of the criticism of the Standard Form was directed at its unilateral nature; under the Standard Form only the client firm was bound by the terms and conditions.[67] Many legal scholars and finance lawyers have long criticized this unilateral nature of the Standard Form.[68] A survey suggested that a majority of borrowers in Japan felt that this Standard Form was unreasonably advantageous to banks.[69] In particular, Section 3 (interests, penalties, etc.) and Section 4 (security interest) have long been considered unduly favorable to

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *Id.* Indeed, the set-off provision unilaterally gave benefit to banks; a bank was given the right of set-off under the Standard Form, while a client firm was not.

[67] The Standard Form was not enforceable by a client firm against a bank. When the Standard Form was amended in 1977, its unilateral agreement style (*sashiire hōshiki*) remained unchanged. Criticism against the unilateral style has existed until recently.

[68] *See, e.g.*, THE BANKING TRANSACTION AGREEMENT AT THE ERA OF REVIVAL OF CONTRACT, Ginkō Hōmu 21 VOL. 45 (2001) [hereinafter GINKŌ HŌMU 21].

[69] Research by the Ministry of International Trade and Industry (now, the Ministry of Economy, Trade, and Industry) indicated that about 63% of Japanese firms consider that the model form of Banking Transaction Agreement is unreasonably beneficial to banks. YAKKAN NO ARIKATA, *supra* note 59.

banks.[70] Many scholars and lawyers have argued over reforms that banks should adopt; some institutions have introduced trial models for new banking agreements.[71]

Indeed, banks reserve various rights under the Standard Form in order to protect their credits. Section 3 of the Standard Form provides that the bank is entitled to change any interest or discount rates, guarantee fees, or other terms and conditions to a reasonable degree at any time when circumstances surrounding a financial market have dramatically changed or other events have occurred that make such change appropriate. Similarly, Section 4(1) provides that the bank may require the borrower to submit additional security when an event occurs that reasonably causes the bank to feel it is necessary to secure its credit.[72]

Banks are not completely protected by the Standard Form, however. Interestingly, neither the Standard Form nor any other related contract document provides representations and warranties ("warranties") or affirmative and negative covenants ("covenants").[73] Thus, at least on the face of the agreement, Japanese banks do not restrict or limit the management of borrowers, whereas in the United States, typical loan agreements always provide covenants restricting the borrower's managerial discretion.[74] In this respect, Section 12 of the

[70] 21% of Japanese firms feel that Section 4 (Security Interests) is unreasonably disadvantageous to them, and 14% of them feel that Section 3 (Interests and Penalty etc.) is unreasonably disadvantageous. *Id.*

[71] *See* GINKŌ HŌMU 21, *supra* note 68.

[72] Interestingly, most of the recent financial statements of major listed firms include a footnote indicating that, as an important risk factor, all borrowings from banks are subject to the terms of the Banking Transaction Agreement, and by the relevant provision of the Agreement, the firm shall be required to post additional security interests when requested by the banks.

[73] *See* Takayoshi Okabe, *Saikensha Hogo No Tameno Kaikei Wo Kangaeru [Consideration of Accounting for Protecting Creditors], in* 40-2 KANSAI-DAIGAKU SHŌGAKU RONSHŪ 1-25 (1995) (explaining that covenants were rarely provided in bank loan agreements in Japan, while they are often provided in public bond issuance cases); *See also* Takahiko Inoue, *Sanwa Ginkō Ni Okeru Cobenantsu Jōkō Tsuki Yūshi No Dōnyū [Sanwa Bank's Introduction of Loan Agreements with Covenants Clauses], in* 1595 KINYŪ HŌMU JIJŌ 28 (2000) (explaining that covenants have not been utilized in Japanese banking transactions except for bonds, syndicate loans, and commitment lines).

[74] For typical provisions of covenants in loan agreements for U.S. banks, see, for example, Kenneth J. Goldberg, *Lender Liability and Good Faith,* 68

Standard Form specifies the borrower's obligation to submit necessary information to the bank when the bank so requests or when there is a substantial change in the borrower's assets, management, or operational results. However, even such reporting obligations never establish the borrower's concrete managerial standards.

The lack of warranties and covenants has led to loan terms which are much shorter than the project lifetimes. If banks cannot effectively conduct interim monitoring by providing strict covenants in loan agreements, they can instead strengthen their legal position by shortening the terms of loans. They can then conduct monitoring every time a borrower renews its loans.[75] To compensate for the discrepancy

B.U. L. REV. 653, 657 n.31 (1988); Robert M. Lloyd, *Financial Covenants in Commercial Loan Documentation: Uses and Limitations*, 58 TENN. L. REV. 335, 340-43 (1991). *See also* Elizabeth A. Dellinger, *Doing Deals 2003: Understanding the Nuts & Bolts of Transactional Practice in an Uncertain Market–Bank Financings*, 1356 PLI/CORP 541, 556(2003). According to the PLI Report, affirmative and negative covenants are intended to "(a) ensure that the borrower continues business as contemplated; (b) protect security interests and priority; (c) keep cash in business; and (d) serve as an "early warning system" if there are problems with credit." *Id.* at 555. What covenants a particular loan agreement provides is determined by considering various factors such as the size of the loan, the borrower's financial strength, the borrower's bargaining power, and the lender's degree of comfort with the borrower's management. Typical examples of covenants are (i) negative pledge, (ii) prohibition against sale and leaseback transactions, (iii) covenant against junior lien, (iv) restrictions on additional unsecured debt, (v) minimum net worth, (vi) restrictions on guaranties, (vii) restrictions on dividends, (viii) restrictions on stock redemption, (ix) restrictions on compensation, (x) restrictions on payment of certain debt, (xi) limitations of dispositions of fixed assets, (xii) no change in business, (xiii) no merger or consolidation, and (xiv) other financial covenants such as minimum fixed charge coverage ratio, cash flow coverage ratio, interest coverage ratio, and, debt to total assets ratio.

[75] In fact, Japanese loan agreements are relatively shorter with regard to the term of each loan. One research study showed that from 1982 to 1986, more than 60% of loan contracts became due within a year. J. Mark Ramseyer, *Legal Rules in Repeated Deals: Banking in the Shadow of Defection in Japan*, 20 J. LEGAL STUD. 91, 105 (1991). In this respect, Frank Packer described the role of long-term credit banks as secondary lenders to Japanese firms. It is worth noting that city banks and long-term credit banks had played different roles in financial transactions. City banks were mainly required to supply short-term loans to borrowers, whereas long-term credit banks specialized in fixed rate long-term financings backed up by issuing coupon bonds. Main banks, which are usually city banks, had been suppliers of short-term cash

between the project term and the loan term, a loan contract must contain an implicit agreement that the bank will renew the loan unless the borrower is insolvent with no hope to revive. If this practice of incorporating an implicit commitment for loan renewal matures, it will gradually evolve into a much stronger social expectation that banks will rescue borrower-firms.

The lack of warranties and covenants has made Japanese banks rely on security interests[76] While providing warranties and covenants in loan agreements enables lenders to verify the reliability of borrowers effectively, the lack of those provisions required another set of system to verify borrowers and solve the problem of information asymmetries.[77] If a firm has a bad reputation, banks tend to obtain a security interest or a third party guarantee as a hostage.[78] Japanese banks believe that threatening a borrower with forfeiting collateral or enforcing a guarantee creates an incentive on the part of the borrower to comply with the terms of the contract.[79] As long as banks rely on security interests when they enter into transactions, they must exercise their right to hold these interests when borrowers are in default. As a result, a significant number of court

flow to firms for operational purposes, but nonetheless sometimes provided loans for particular projects of borrowers. Otherwise, cooperative financing (*kyōchō yūshi*), in which city banks asked long-term credit banks to finance for their preferred customers in return for their purchase of coupon bonds, was often adopted. *See* Frank Packer, *The Role of Long-Term Credit Banks Within the Main Bank System*, *in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 9.

[76] In the 1980s, almost 60% of total loans were secured by security interests or guarantees. *See* Ramseyer *supra* note 75, at 101-02

[77] "A law-centered approach" to the information asymmetry problem in commercial transaction "would call for the development of warranties and covenants that the party with superior information would give to the party with inferior information." Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEO. L.J. 2225, 2226 (1999).

[78] Ramseyer observes that a bank will not find it advantageous to enforce its security interests for various reasons, such as the bank's inability to manage the firm, the prohibition by the law to enforce the collaterals, and the possibility of failing to sell the collaterals at high price. Ramseyer, *supra* note 75, 102-03.

[79] According to Packer, one "systemic characteristic" of the Japanese financial system is that "with the goal of safe transactions in mind in principle important financial transactions, such as corporate bond issues, bank loans and interbank transactions, will be secured with collateral." Packer, *supra* note 75, at 169.

cases in the field of security interests has accumulated. In fact, almost every provision of the model form for Banking Transaction Agreements has been litigated; the largest banks often retain as many as forty law firms to advise them in these litigations, consulting with up to two hundred attorneys.[80]

In essence, the characteristics of contract practice in traditional bank-borrower relationships are highly standardized and inflexible, usually defined by the provisions of a standard agreement form. In Japan, the practice of preventive law or *ex ante* legal planning was never developed, and there is little contract negotiation in banking transactions. Provisions for *ex ante* informational verification such as representation and warranties are not seen in typical banking agreements, and affirmative and negative covenants, which require borrowers to comply with certain requirements during the term of a loan for monitoring purposes, are rarely provided, except for special financing arrangements such as large-scale syndicate loans. The term of the typical bank loan is relatively short, and banks tended to rely on security interests when providing loans to firms. Banks have relied heavily on litigation in order to establish general standards for banking practice.

2. *Traditional Theory – Monitoring by Main Banks*

Why did the uniform contract practice using the Standard Form persist in the bank-borrower relationship? The Standard Form is efficient only when it comes with other bonding mechanisms. In this context, banks relied on mortgages and guarantees to protect their legal rights, and shortened the length of contractual terms to strengthen their legal position. If the term of the loan is shorter, firms need to protect themselves from banks' opportunistic acts by diversifying their sources of funding.[81] Even though this package makes a loan more efficient for both the bank and the client firm, it remains a mystery how such a package could be efficient in all transactions. An important question arises in this respect: is it possible to develop an economic logic that would explain why such a standardized and inflexible practice has been maintained in bank-borrower relationships throughout the postwar period? There

[80] *See* Milhaupt, *supra* note 12, at 43-44 (arguing that banks use the legal system extensively for their own protection).

[81] *See* Ramseyer, *supra* note 75, at 104-05.

is a mystery as to why main banks have not provided warranties and covenants in their loan agreements, while they have continually encountered serious problems of adverse selection[82] and moral hazard.[83]

Lower Monitoring Costs. The simplest and most persuasive explanation of why Japanese loan agreements did not have warranties and covenants is that banks were able to solve information asymmetries on their own with lower monitoring costs.[84] This hypothesis supposes that gains from providing

[82] The lack of warranties in loan agreements may cause adverse selection problems. If a main bank did not have sufficient information with respect to firms' businesses, the main bank would estimate their risk premium higher via every firm. The safest firms would consider the risk premium inappropriate and reject the main bank's offer. Because of the safest firms' withdrawal, the main bank's risk average would become higher, resulting in the increase of the risk premium. In the worst-case scenario, this process continues until all firms withdraw. While the solutions to this adverse selection problem is to request firms to represent and warrant that assertions made by firms are true and correct, banks did not incorporate such warranties into their loan agreements. *See* J. Mark Ramseyer, *Explicit Reason for Implicit Contracts: The Legal Logic to the Japanese Main Back Sytem, in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 9, at 231.

[83] The lack of covenants in a loan agreement may cause moral hazard problems. If a bank cannot monitor a borrower perfectly, the borrower would pretend to invest in lower-risk projects prior to obtaining loan from the main banks, but after obtaining the loan, it would actually invest in higher-risk projects. *Id.* at 245-46.

[84] In a traditional sense, main banks play a key role in monitoring the management of firms and rendering assistance in case of managerial crisis or financial failure. Main banks' monitoring has three stages, all of which are integrated and exclusively delegated to main banks. The first stage is an ex ante monitoring, which refers to assessment of firms prior to the main banks' investment in firms. The second stage of interim monitoring refers to assessment of firms' ongoing management activities and operations during the loan period. The third stage of ex post monitoring refers to the verification of the outcome of a particular loan or credit transaction. There is a strong social expectation regarding the main bank system that a main bank should maintain its long-term relationship with a client firm and, when the client is in crisis, informally restructures said failing firm. *See, e.g.*, Masahiko Aoki, *Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View, in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 9, at 109 [hereinafter Aoki, *Monitoring Characteristics*]; Milhaupt, *supra* note 12, at 23-24. *See also* Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 L. & SOC. INQUIRY 425 (2002) (supporting the argument that main banks function as delegated monitors and rescuers); *but see* Yoshio Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC.

covenants would not have been greater than the costs associated with the specification of such warranties and covenants in contracts. It presupposes that a main bank, from which a firm obtains its largest share of borrowing, has been able to achieve effective monitoring at lower costs because the main bank's holding of major settlement accounts significantly enhanced their ability to judge the organizational and managerial capacity of firms.[85] According to Masahiko Aoki, at the heyday of the main bank system, when the Japanese economy was still catching up in terms of technological capability, observing the managerial and organizational ability of an investing firm to absorb and improve upon engineering know-how developed abroad was more important as a monitoring strategy than assessing the commercial and engineering values of emergent technology. Thus, according to Aoki, information received by main banks through their long-term relationships with client firms was sufficient for monitoring purposes. Therefore, it may be reasonable that monitoring functions were delegated solely to main banks.[86] When engineering assessments of technologies were required, such assessments were often delegated to the former IBJ, the leading long-term credit bank.[87]

However, even if this hypothesis plausibly explains the efficient monitoring function of main banks at the development stage of the Japanese economy, it only explains banks' activities at the heyday of the main bank system. By the time the Japanese economy matured and firms became engaged in fierce international competition, the economic valuation of new engineering and technology must have become more important. The traditional focus on firms' operational ability might have been insufficient to monitor firms at this stage.

INQUIRY 401, 417-18 (2002) (arguing that main banks were neither delegated monitors nor rescuers).

[85] *See* Aoki, *Monitoring Characteristics, supra* note 84, at 118.

[86] *See id.* The proposition that main banks are delegated exclusive monitors is strongly criticized. Critics argue that not only is there no evidence, but also that this proposition is highly unlikely in theory. They argue that if monitoring by multiple banks is a "waste," rational firms will simply try to borrow from fewer banks in order to reduce their credit costs. However, at the heyday of the main bank system, large Japanese firms borrowed only 15 - 20% from their lead bank and borrowed the rest from many competitors, while the leading main banks could afford to lend more. Miwa & Ramseyer, *supra* note 84, at 419.

[87] *See* Aoki, *Monitoring Characteristics, supra* note 84, at 118.

Nonetheless, the contract practice of banks remained the same throughout the postwar period. Banks should have provided covenants if doing so would have prevented inefficient management.

Punishment of Management. One of the most common explanations of banks' failure to offer covenants is that they were able to prevent moral hazard problems by punishing bad managers through *ex post* monitoring. It has been suggested that a main bank, as the largest lender, is responsible for pursuing *ex post* monitoring through manager replacement and restructuring with an implicit commitment to rescue the firm in its financial distress.[88] However, it is still doubtful that the punishment effectively prevents moral hazard, as there is still a possibility that management's moral hazard is harmless to shareholders if losses to firms are ultimately compensated by the main banks' implicit commitment to rescue them.[89] This implicit undertaking leads management to invest in higher re-

[88] The famous Mazda Motor Corp. restructuring is a typical example. *See* Richard Pascale & Thomas P. Rohlen, *The Mazda Turnaround,* 9 J. JAPANESE STUD. 219, 228-33 (1983). *See also* Paul Sheard, *Main Banks and the Governance of Financial Distress, in* THE JAPANESE MAIN BANK SYSTEM, *supra* note 9.

[89] It is widely recognized that main banks informally undertake the restructuring of failing firms. It is often described that main banks offer *insurance* against borrowers' failure, and borrowers pay main banks some consideration as an *insurance premium* for this *insurance* function. The *insurance premium* is paid in various forms such as a deposit to a bank account, and subscription of the bank's stock. *See* Sheard, *supra* note 9, at 213-26 (showing examples of main bank involvement in restructuring of listed firms). However, some scholars arguably claim that main banks in fact do not offer *insurance* at all. Ramseyer argues that Japanese main banks have more chances to encounter cases where they should rescue failing firms than do American banks because, unlike the bankruptcy legislation in the United States, Japanese bankruptcy laws do not require Japanese lenders subordinate their claims to those of other creditors. Ramseyer, *supra* note 82, at 247-51. Miwa and Ramseyer argue that main bank theorists look only to the *ex post* incidents when they argue that main banks actually offer an *ex ante* insurance arrangement. According to them, historical records indicate that "main banks do not stay around to help troubled firms," but they in fact are likelier to abandon their troubled clients. Indeed, "[i]f you owe the bank $100,000 the banks own you; you owe the bank $100 million, you own the bank." Once a bank encounters a danger of incurring large losses due to the financial trouble of borrowers, it often has an incentive to "lend a bit more (or to cut the interest rate, or to write off a bit of the debt) to nurse the firm back to health." Miwa & Ramseyer, *supra* note 84, at 417.

turn projects without risks.[90] If there was any possibility that banks would suffer from serious moral hazard problems, reasonable banks should have realized the importance of covenants that might reduce moral hazard risks. If they had relatively strong bargaining power vis-à-vis firms, banks could have requested covenants without any difficulty.

Another explanation for the management penalty hypothesis suggests that losses resulting from rescue were eventually compensated by the expansion of deposit balances. Because of the low ceiling on deposit interest rates, a key element of banks' long-term business strategy was expanding their deposit balances. Recognizing this, MOF awarded additional branch offices to city banks that rescued major firms whose failure might have caused serious social problems. It has been suggested that often a bank's loss arising from the borrower's distress was offset by the gain resulting from the expansion of the deposit balance. However, if rescue is compensated by the expansion of deposit balances through the grant of new branch licenses, banks no longer need to monitor firms. Banks are incentivized to expand their credit volume without conducting a thorough assessment of borrowers, as long as they are guaranteed compensation in the form of additional branches upon a borrower's failure. In sum, both banks and firms will face moral hazard problems.

MOF historically has monitored financial institutions. It has long been suggested that the informal discretionary role played by MOF has compensated for the absence of effective monitoring by shareholders. Main bank theorists argue that the inefficient management of banks was strictly constrained

[90] Suppose that a firm borrowed $10 million from a bank with the implicit understanding that the cash would be used for lower risk projects, but after the drawdown, the managers of the firm, knowing that the loan agreement did not provide any covenants regarding the use of cash, invested this $10 million in other more risky projects. If the main bank is asked to support the firm through an implicit commitment to rescue the firm (or if the bank is asked to subordinate its claim when the projects fail), shareholders' profit calculation is different. If projects succeed, shareholders can obtain more gains than when the firm invested in lower risk projects, and even if projects fail, shareholders do not incur losses as long as the bank compensates them. If the management is reluctant to invest risky projects for fear of punishment, shareholders will offer to pay the management more as compensation for the management's risk of punishment. *See* Ramseyer, *supra* note 82, at 246.

by periodic inspections by MOF and the Bank of Japan. They argue that the protection of banks by the convoy system[91] was counterbalanced in substantial part by the close supervision and prudential control of the regulatory authorities. The inspection division (*kensabu*) of the former MOF's Banking Bureau inspected the books of banks, and if any irregularity was found, it had the authority to advise on how to solve the problem. Similarly, the Bank of Japan closely monitored the daily operations of banks, and regularly conducted on-site examinations.[92] However, the economic bubble in the late 1980s revealed that these inspections did not, in the end, neutralize the effect of the management inefficiency latent in the convoy system.

Total Efficiency in Japanese Corporate Governance. Main bank theorists argue that banks' emphasis on *ex post* monitoring can be explained within the context of the internal organizational character of Japanese firms.[93] According to Aoki, employees have an incentive to work hard if banks threaten to intervene in the management of distressed firms.[94] Traditional literature has argued that although, under the lifetime employment system, employees with general skills are likely to shirk their duties in theory, employees nonetheless work hard because they fear main bank intervention during times of distress. Those advocating this view suggest that a main bank, on the

[91] The "convoy" system refers to the regulatory policies and rules that Japanese financial regulators set with the weakest member of the industry sector in mind. Under the convoy system, members of the group are allowed to move no faster than its slowest member. Curtis J. Milhaupt & Geoffrey P. Miller, *Cooperation, Conflict, and Convergence in Japanese Finance: Evidence From the "Jusen" Problem*, 29 LAW & POL'Y INT'L BUS. 1, 8 (1997).

[92] Aoki, *Introductory Overview*, *supra* note 9, at 31.

[93] See Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LITERATURE 1, 10-15 (1990) [hereinafter Aoki, *Economic Model*]. If the Japanese *keiretsu* system is efficient, it seems to work well only within its special context and, largely because it relies on a relatively passive and deferential style of monitoring. John Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1301-02 (1991).

[94] Because of no labor market and no transferable skill, a discharged employee would incur huge penalties. Thus, main banks' threat of managerial intervention works effectively as an incentive not only to management but also to employees. *See* Aoki, *Economic Model*, *supra* note 93, at 15. Miwa and Ramseyer argue that this theory is too idealistic and prisoners' dilemma Aoki posits does not make sense because main banks in fact have no disciplinary function. *See* Miwa & Ramseyer, *supra* note 84, at 420.

other hand, is relatively slack in interim monitoring because it must obtain the advance consent of other *keiretsu* members before it intervenes in a *keiretsu* firm's management.[95] Under this hypothesis, it might make sense that covenants are less important for these parties.

This argument, however, has been criticized by many scholars. It is implausible that the managers of each city bank's branch office always make their transactional decisions based on this assumption about Japanese inter-firm structures. The reality is that a central credit administration department has relatively significant decision-making power, and this department usually relies on firm financial statements in conducting its credit analysis.[96] Furthermore, and even more surprisingly, Japanese firms regularly switch their main banks and smaller firms even transfer between *keiretsu* groups.[97] If this is the case, the suggestion that main banks defer from managerial interventions due to the consensual process in *keiretsu* is questionable. Although Aoki's theory is supported, in some sense, by the high growth rate of the Japanese economy after the end of World War II, it is still doubtful whether this progress is in fact a result of the *keiretsu* system.[98]

[95] Coffee observes that the *keiretsu* serves the interests of management more than those of the shareholders. Because main banks hold "an ownership level that is below five percent by definition," their monitoring role is significantly constrained. Presumably, fellow *keiretsu* members will consensually restrict the main bank's monitoring within those when "the demonstrated delinquency of a member firm threatens the *keiretsu* as a whole." Coffee, Jr., *supra* note 93, at 1298-1301.

[96] A website describes an interesting phenomenon that occurs in banks' decision-making process. Usually, under the uniquely Japanese decision-making (*ringi*) process, it takes at least two or three days for a person in charge to prepare a circular (*ringi*) document for approval by management. Once the document is sent to the manager of a branch office, it takes at least one or two days for the manager to approve the project. Finally, the document is sent to the headquarters credit administration department that finally approves the project, but it usually takes at least two or three days for the credit administration department to give a final authorization.

[97] *See* Ramseyer, *supra* note 75, at 98 n.18.

[98] As Coffee indicated, "one may well ask whether the keiretsu system was responsible for this rate of return or, rather, whether the rate of return was responsible for shareholder tolerance for the *keiretsu* system." *See* Coffee, Jr., *supra* note 93, at 1300-01.

3. *Rethinking the Interaction between the Main Bank System and Relational Practice*

If all the conventional hypotheses about Japanese contract practice are imperfect, a new theory is needed. As discussed in Part II, weakness in preventive legal practice was one factor which shaped the evolution of Japanese corporate governance. As business contract practice could not catch up with the rapid growth of the Japanese economy, firms could not write discrete contracts for their deals. The primary reason contract practice in bank-borrower relationships remained inflexible is that drafting costs remained extremely high. Because of these high drafting costs, banks could not offer covenants and warranties in their loan contracts.

If a bank cannot write covenants and the bank-borrower relationship is bound by the regime of relational practice, the bank may seek a bond to ensure self-enforcement. In order to avoid issues of borrower moral hazard, a bank will often request that the borrower submit security interests such as land mortgages or individual guarantees. A bank will also incorporate stricter contract terms that enable it to increase interest rates, discount rates, or guarantee fees at its own discretion, or, alternatively, terms that enable it to request additional security interests if necessary. Indeed, the Standard Form has incorporated such strict terms that benefit only the bank.

On the other hand, the firm, which does not have sufficient means of constraining the bank's opportunism, would like the bank to maintain a degree of fairness and to act in good faith throughout the loan period. The firm may select a bank that places a special emphasis on structural stability, because, as explained above, stability of corporate structure and management policy allows the firm to predict that the future manager will have the same level of reciprocity as the current manager. Maintaining stability is essential if banks want to keep their clients in the regime of bank-centered corporate finance. Indeed, in business transactions in Japan, banks are expected not to abandon their clients easily. A firm will not borrow from banks, but will instead procure its funding from the securities market, if it fears that banks will act opportunistically by rejecting loan renewals without good cause.

The implicit *insurance* commitment by main banks can be understood in this context. In order to secure the implicit commitment, a society will create a third party adjudication system using reputation as a signal. The convoy style of banking regulation navigated by MOF has supported the creation of a standard for reputation. This standard asks whether the bank, in the past, ever abandoned any major failing firm whose failure would have had a seriously negative impact on the Japanese economy. In this sense, the implicit *insurance* commitment itself became a reputation signal. Under a relational practice regime, a bank's reputation will deteriorate if it does not rescue firms.

B. *Inter-firm Transactions and Keiretsu Cross-Shareholdings*

1. *Relational Practice in Inter-firm Transactions*

The application of the theory of relational contracts to inter-firm agreements is more straightforward than in its application in the bank-borrower context. In inter-firm contracts, many contingencies are not addressed explicitly in the contract, but instead are left open for renegotiation, which will occur if and when these contingencies in fact cause inefficiencies during the performance stage. For instance, in manufacturer-supplier relationships, a "basic contract" is usually exchanged at the outset.[99] This basic contract determines general obligations, but often does not contain detailed provisions regarding how the parties will address specific contingencies inherent in the transactions.[100]

[99] Banri Asanuma, *Manufacturer-Supplier Relationships in Japan and the Concept of Relation-Specific Skill*, 3 J. JAPANESE & INT'L ECON. 10 (1989). In the automobile industry, the basic contract provides that renegotiation of prices be provided regularly, but it is silent about the detail of a price adjustment mechanism. As a timely delivery in accordance with a supply schedule is an essential factor for just-in-time supply system working perfectly, the basic contract anticipates the supply schedule as an integrated part of contracts. In the electric machinery industry, the basic contract provides an outline of the basic purchasing policy of a manufacturer. This basic contract binds recurrent-type transactions of all manufacturing plants. In its contract practice, a manufacturer's headquarter procurement department, acting on behalf of all of its manufacturing divisions, executes the basic contract with all suppliers, although actual activities differ in each manufacturing division. The detailed terms of supply and purchase that are not provided in the contract are open for out-of-contract negotiation between the relevant manufacturing division of the manufacturer and the supplier in each individual transaction. *Id.* at 3-4.

[100] *See id.* at 3.

As inter-firm contracts are relational, contracting parties must develop effective self-enforcement mechanisms. A typical dispute resolution in inter-firm transactions generally consists of three steps. First, almost all business contracts have a "confer in good faith" clause, which requires that contracting parties be reciprocally fair when a dispute arises in connection with the rights and obligations of the parties. When contracting parties are unable to adjust contract terms through fair renegotiation, contracting parties often resort to informal dispute resolution, in which case a government agency administrating and regulating the relevant market often acts as a third party intermediary. The dispute is not litigated in court until these initial attempts are found to be unsuccessful. In the final stage – litigation – courts will again encourage contracting parties to renegotiate. Judicial decision is the very last of several steps in the dispute resolution processes.

The First Stage: Confer in Good Faith. At the first stage, firms try to renegotiate and amicably resolve disputes by eliminating information asymmetries. An interesting phenomenon is that the confer in good faith clause is (at least in my anecdotal experience) seen in almost all business-to-business contracts.[101] In my personal experience as counsel of a Japanese firm, I was often asked why I had not included the confer in good faith clause if I happened to leave it out of a contract draft. The confer in good faith clause is not merely a boilerplate term unconsciously sneaked into standard form contracts; it is a meaningful provision that requires reciprocally fair renegotiation by contracting parties at the *ex post* enforcement stage. Indeed, officers who are supportive of the confer in good faith clause often express a strong desire to settle, believe that they will be able to settle, and in fact, regularly *do* settle disputes through *ex post* renegotiation.

The Second Stage: Regulatory Guidance. If disputes are not resolved through renegotiation, regulatory agencies often take on the role of informal intermediaries in dispute resolutions between firms, offering solutions from a regulatory policy perspective.[102] When a dispute arises, the regulatory agency often

[101] *See* Kawashima, *supra* note 47.

[102] This type of guidance is called the adjudicatory administrative guidance. *See, e.g.*, MITSUO MATSUSHITA, INTERNATIONAL TRADE AND COMPETITION LAW IN JAPAN (1993); Ken Duck, *Now That the Fog Has Lifted: The Impact*

indirectly intervenes in the dispute, threatening to impose a heavier burden against a party who might have deviated from regulatory standards at some other point in the relationship.[103] Once regulatory guidance is given, contracting parties are often unwilling to challenge that guidance, whether they are pleased with the result or not[104]

Some empirical facts suggest that governments have often played the role of mediator. In the famous Toyo Kogyo's crisis and turnaround, the Ministry of International Trade and Industry (MITI), which was afraid of the impact of Toyo Kogyo's crisis on the regional economy in the Hiroshima area, explicitly instructed Toyo Kogyo's large suppliers to continue their supply transactions with the company consistent with the terms of their agreements.[105] Although this incident is often mentioned as an instance of MITI seeking to implement its industrial policy in order to further the stability of a regional economy, at the same time, it describes MITI's informal enforcement of private agreements between Toyo Kogyo and its suppliers. Instead of seeking a formal restructuring procedure, the suppliers sought a non-legal procedure initiated by a regulatory agency.

The famous Sumitomo Metal dispute is also a typical illustration of a regulatory agency playing the role of arbiter. In order to stabilize the domestic price of steel in the mid-1960s, MITI determined that all domestic steel companies in cartels

of Japan's Administrative Procedures Law on the Regulation of Industry and Market Governance, 19 FORDHAM INT'L L.J. 1686 (1996).

[103] *See, e.g.,* Michael K. Young, *Judicial Review of Administrative Guidance: Governmentally Encouraged Consensual Dispute Resolution in Japan,* 84 COLUM. L. REV. 923 (1984); Yoshiro Miwa & J. Mark Ramseyer, *Capitalist Politicians, Socialist Bureaucrats? Legends of Government Planning from Japan,* 48 ANTITRUST BULLETIN 595 (2003).

[104] Young, *supra* note 103, at 946. The Japanese government often exercises control over the Japanese economy by either recommending a particular production technique or organizing cartels in certain industries. Most industrial policy decisions were put into effect through administrative guidance. However, not all Japanese citizens always complied with this guidance. Firms often opposed the administrative guidance when they found it disadvantageous to comply with it. *See* Steven M. Spaeth, *Industrial Policy, Continuing Surveillance, and Raised Eyebrows: A Comparison of Informality in Administrative Procedure in Japan and the United States,* 20 OHIO N.U. L. REV. 931, 939-40 (1994).

[105] Pascale & Rohlen, *supra* note 88, at 232.

should decrease production by ten percent.[106] When Sumitomo Metal refused to comply with MITI's guidance, the other major steel producers decided to maintain the cartel and asked MITI to force Sumitomo to comply.[107] In response, MITI threatened to use its legal authority under the Foreign Exchange and Foreign Trade Control Law to limit Sumitomo's importation of necessary raw materials to the amount needed to meet the company's allotment as a cartel member.[108]

The Third Stage: Litigation. At the last stage of a dispute resolution process, when all efforts of renegotiation and self-enforcement fail, the dispute will be litigated. However, even in this final stage, Japanese courts often induce contracting parties to reach a fair result amicably. Takeyoshi Kawashima indicated that Japanese litigants were often willing to settle a case through conciliatory processes initiated by courts during the litigation process, and that courts were reluctant to expedite judicial decision, preferring instead to reconcile the litigant parties.[109] Personally, I have seen cases where courts have not only suggested that judicial-decision-seeking litigants reconcile, but have actually forced them to do so.

[106] Spaeth, *supra* note 104, at 936-37. For another example of cartel guidance, MITI often intervened in oil industry cartels. *See, e.g.*, Malcolm D. H. Smith, *Prices and Petroleum in Japan: 1973-1974–A Study of Administrative Guidance*, 10 L. JAPAN 81 (1977); Japan v. Sekiyu Renmei, 983 HANREI JIHŌ 22 (Tokyo High Court, Sept. 26, 1980) (an oil cartel production restriction case); Japan v. Idemitsu Kosan K.K., 985 HANREI JIHŌ 3(Tokyo High Court, Sept. 26, 1980) (an oil cartel price fixing case).

[107] Spaeth, *supra* note 103.

[108] While administrative agencies implement their administrative guidance based on the belief that informal guidance will result in a fair distribution of social welfare, determining what is fair is an extremely difficult task. Empirical facts suggest that the administrative guidance often failed to achieve fair distribution. A series of cartel guidance by MITI was motivated by MITI's policy to protect particular industries, but it is doubtful whether this cartel arrangement brought about an end societal benefit. Moreover, it is often said that administrative agencies often sought whatever might benefit the agencies themselves rather than what might advance social welfare. The Sumitomo Steel incident implied that MITI might have treated major steel companies differently according to whether they hired MITI bureaucrats as their executives. *See, e.g.*, Spaeth, *supra* note 104, at 936.

[109] *See* Takeyoshi Kawashima, *Dispute Resolution in Contemporary Japan*, *in* LAW IN JAPAN: THE LEGAL ORDER IN A CHANGING SOCIETY 48 (Arthur Taylor von Mehren ed., 1963).

2. *Traditional Theory of Cross-shareholding and the Keiretsu System*

It has been suggested that the interlocking cross-shareholding of the *keiretsu* system helps to reduce opportunism in business-to-business transactions. The simple five-party model outlined by Gilson and Roe provides an illustration.[110] The five parties consist of one distributor, two suppliers, one bank, and one assembler. They negotiate a cooperative structure for producing goods and each purchases one-fourth of a specified fraction of the other four companies' shares. Given this model, suppose that the market price of assembly materials skyrockets so that the supplier can no longer maintain its current price level. If the assembler tries to act opportunistically in this situation, the other four firms can threaten the assembler by announcing that they will sell their shares of its stock. Since the *keiretsu* firms' disposition of the shares increases the risk of a hostile takeover, the assembler will refrain from acting opportunistically. Therefore, cross-shareholdings help to enforce the commitment to good faith negotiation of new transaction terms following the occurrence of an unexpected event.

As an illustration of these relation-specific investments, the role of Japanese trading companies (*sōgō-shōsha*) as a risk bearer supports this argument. For example, in the steel industry, a giant steel producer appoints a trading company as a distributor, through which steel products are distributed to the first-level wholesaler, and the first-level wholesaler will distribute to the second-level distributors under the vertical *keiretsu*.[111] The responsibility of each player is also fixed under the fixed distribution channeling; the giant steel producer is responsible for the quality of steel products, whereas the trading company bears credit risks. The first-level wholesalers, who are often subsidiaries of the trading company, will focus primarily on sales planning and other product-related services. In doing so, the giant steel company can concentrate on pro-

[110] *See* Gilson & Roe, *supra* note 10, at 884.

[111] There are two types of *keiretsu*. One is a horizontal *keiretsu* (financial *keiretsu*), which is made of one of the former *zaibatsu* groups (Fuyō, Sanwa, Daiichikangyō, Sumitomo, Mitsui, and Mitsubishi) and now is loosely formed through mutual stockholding. The other is a vertical *keiretsu* (capital *keiretsu*), which is linked to each other by a parent and subsidiary relationship. *See* AOKI, *supra* note 8, at 119-20.

duction and other technical issues. On the other hand, the trading company concentrates on credit-risk management, and the first-level wholesalers help the trading company with its product distribution.

However, the theory that cross-shareholding functions as a relation-specific bond is too idealistic to fully explain the concept of relational theory. First, the percentage of cross-shareholding is usually not large enough to threaten an opportunistic firm.[112] Liquidation of cross-shareholding will not always effectively threaten firms, as liquidation of only a fraction of shares does not necessarily raise the possibility of hostile takeovers. Second, according to this theory, transactions with firms from different cross-shareholding groups will be governed by discrete contracts, especially in the absence of relation-specific investments. But this is not the reality. To be sure, the relational nature of Japanese contracts is seen more in transactions within *keiretsu* as opposed to outside *keiretsu.* In my experience, very large projects pursued by *keiretsu* groups will often have shorter contracts than smaller transactions involving non-*keiretsu* firms. However, the reality is that both inter-*keiretsu* contracts and non-*keiretsu* contracts are likely to be incomplete and relational. One remaining question is why non-*keiretsu* contracts, which are often not bound by relation-specific asset exchange, are incomplete.

3. *Rethinking the Interaction between the Keiretsu System and Relational Practice*

The conventional argument that the *keiretsu* cross-shareholding is a relation-specific exchange of bonds among *keiretsu* members is imperfect. As mentioned above, liquidation of the *keiretsu* does not necessarily raise the possibility of hostile takeovers and thus does not effectively threaten firms. The importance of the *keiretsu* relationship in the context of relational asset exchange is relatively small, since *keiretsu* firms transact just as much with non-*keiretsu* firms as with *keiretsu* firms.

Again, a new theory is needed. As discussed in Part I, the starting point for analysis of the interaction between Japanese corporate structure and relational practice is the fact that

[112] Even for the famed diversified corporate groups, the ratio of cross-shareholding is about 20%. J. Mark Ramseyer, *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L. Rev. 1, 23 (1988)

firms could not write contracts simply because Japan had very few business lawyers. If drafting costs are high, businesses want to deploy self-enforcing devices using relation-specific investments or reputational sanction mechanisms. However, it is unrealistic to suppose that those self-enforcing devices exist commonly and pervasively in all markets and all transaction relationships. Thus, in a transaction where those bonding mechanisms are weak, a firm encounters the problem of how to verify its counterpart. Without a specific bonding mechanism, the parties might resort to developing social norms, such as reciprocity, fairness, good faith, and mutual trust. Developing those social norms makes a psychic level of self-enforcement more realistic, and thus constrains opportunism.

Even in a society that develops these social norms, businesses must verify whether their transaction partners actually perceive and comply with the ideals of reciprocity, good faith, or fairness. Thus, firms are likely to rely on repeat deals in which the future transaction itself is an intangible asset exchanged as a bond. Even with a cooperative scheme of repeat deals, however, firms are still exposed to the risk of an end game dilemma. A party wants its counterpart to a level of reciprocity sufficient to constrain opportunism, but the party does not know who the manager of its counterpart will be at the future end game stage. Thus, the party must make predictions about the counterpart's future managers based on the corporate structure adopted by the counterpart. Stability in the corporate structure implies stability of shareholders, managers, officers, and employees. A future manager is more likely to be similar to the current manager if the influence of the current manager lasts longer and management policy remains unchanged. Eventually, the party will select a counterpart firm based on signals of a preference for stable business structures. The shareholding structure and employment policy of a firm are such signals. Stable cross-shareholding and lifetime employment thus constitute important reputational capital.

This analysis yields several important implications. First, attempting hostile takeovers will deteriorate a firm's reputation. A firm that attempts a hostile takeover will be recognized as a firm that does not value social stability, and will therefore encounter difficulty entering into relational transactions. Interestingly, in a recent hostile takeover attempt by an Internet service provider, Livedoor Co. Ltd ("Livedoor") against a Fuji-

Sankei group company, Nippon Broadcasting System Inc. ("Nippon"), Nippon's management argued that its poison pill defense was justified as Livedoor's takeover might trigger the end of its contract relationship with Fuji-Sankei group member firms and prominent artists and TV personalities.[113]

Second, *keiretsu* itself constitutes a reputation. A *keiretsu* firm that fears its reputation will deteriorate once it leaves the keiretsu group will not sell shares of other *keiretsu* members' stock. A firm in a *keiretsu* group is recognized as one that: (i) has a higher degree of stability in its corporate structure; (ii) is less vulnerable to hostile takeovers; and (iii) has a steady stream of relational transactions among *keiretsu* members. Indeed, one of the most important issues discussed within a *keiretsu* group is the administration and protection of the *keiretsu* trade name and trademark. For instance, Mitsubishi group established a Mitsubishi Name and Trademark Committee (*Mitsubishi Shamei Shōhyō Iinkai*), which has administered the license and use of the Mitsubishi trade name and trademark in order to preserve the reputation of the Mitsubishi mark.[114] Decisions made by the Mitsubishi Name and Trademark Committee are reported to the Mitsubishi Friday Club (*Mitsubishi Kinyō Kai*), a committee comprising of presidents and chairmen of 29 Mitsubishi companies.[115]

C. *Rethinking the Lifetime Employment System*

1. *Traditional Theory*

Traditional Japanese corporate governance theory indicates that Japanese firms offer the promise of lifetime employment together with the hierarchy of the *nenkō* system, in order to give workers an incentive to invest in firm-specific human capital.[116] Under the *nenkō* system, increasing seniority is accompanied by higher salaries with the ultimate goal being the attainment of a position on the board of directors (the insig-

[113] Nippon Hōsō K.K. v. Raibudoa K.K., 1173 HANREI TAIMUZU 125, 132-33 (Tokyo High Ct., Mar. 23, 2005).

[114] *See* Mitsubishi Name and Trademark Committee Homepage HH , http://www.syameisyohyo.org (last visited July 17, 2005).

[115] For the detailed explanation of Mitsubishi group, see a portal site of Mitsubishi companies, http://www.mitsubishi.com/e/index.html (last visited July 17, 2005).

[116] *See* Gilson & Roe, *supra* note 11, at 509.

nia of those individuals who contribute the most).[117] Generally, employees are under-compensated in their early years with a company but over-compensated in the later stages of their careers.[118]

Scholars traditionally explain that the advantage of the lifetime employment system is that employees who acquire firm-specific human capital will produce larger rent than those who do not. It has traditionally been argued that the reason why shareholders continue to permit the lifetime employment system knowing that it often results in creating idle assets (redundant workers) during an economic recession is that rents produced by firm-specific investments outweigh these disadvantages. The Japanese lifetime employment system has a mechanism that gives employees an incentive to develop firm-specific (contextual) skills, while they are given relatively less incentive to develop functional (universal) business skills.[119] The accumulation of firm-specific skills by employees is extremely valuable for the employer, which is why, under this system, employees who belong to the firm for longer periods (*haenuki*) get higher positions than those who previously worked for other firms (*tozama*).[120] For an employee who desires to spend his entire career in one firm (or an employee who knows that a weak labor market makes it difficult to change jobs), acquiring firm-specific skills is more attractive than acquiring universal skills, because he knows that firm-specific skills will easily make him superior to his rivals.[121]

Indeed, firm-specific skills, such as Toyota's *kanban* (just-in-time) system, may be an essential part of the manufacturing process in Japanese firms. However, employee long-term commitment under the lifetime employment system and high productivity do not necessarily go hand in hand. The productivity of white collar workers is less likely to be proportionate to their investment in firm-specific skills. Finance, accounting,

[117] *See* Milhaupt, *supra* note 6, at 2093.

[118] *See, e.g.*, *id.* at 2092.

[119] *See* Aoki, Economic Model, *supra* note 93.

[120] If a Japanese firm does not treat *haenuki* well, less incentive would be given to those employees who devoted their lives to the firm under the lifetime employment system.

[121] Traditionally, scholars specifically indicate that the firm-specific skills can be seen in manufacturers' production process such as the *kanban* system or the job control unionism.

and sales promotion skills are more universal than firm-specific. Engineers may be more inclined toward firm-specific development of technology, but the core of the technology will often be disclosed to the public through the application for patents granting exclusive use of the technology. In response to the argument that firm-specific skills are highly valuable in blue collar positions, consider quality control circles (QC circles). A QC circle is an internal organization in which blue-collar employees discuss quality control in the manufacturing process and supply chain management. Effective participation in this organization does not necessarily require firm-specific skills.[122] New employees may have more to contribute than long-term employees because they bring fresh ideas to the QC circle. In fact, firm-specific skills are often considered a symbol of a closed and inefficient society. Therefore, encouraging employees to develop firm specific skills does not necessarily ensure increased productivity. The conventional analysis that lifetime employment facilitates firm specific skills does not have great appeal.

2. *Rethinking the Interaction between the Lifetime Employment System and Relational Practice*

Under the lifetime employment system, employer-employee relationships are relational. As employers are not able to foresee contingencies inherent in employment relationships, employment agreements rarely are written in detail. Since each employee is expected to spend his or her entire career with one company under this system, it is almost impos-

[122] The quality control (QC) circle is perhaps the most widely advocated participatory management technique in Japan. QC circles are small groups of workers (usually no more than ten per group) that meet weekly for one or two hours to discuss work problems and potential improvements in the production process. A successful program will usually involve a plantwide system of circles, but each circle includes workers from only one department, with discussions limited to issues affecting that department. These discussions, run by the workers but with supervisory personnel present and involved, typically generate recommendations for specific improvements, which are then passed on to management for consideration. Approval is routinely made, although management retains the power to refuse any recommendation made by the circle. *See* Note, *Participatory Management Under Sections 2(5) and 8(a)(2) of the National Labor Relations Act*, 83 MICH. L. REV. 1736, 1740 (1985) (discussing legality of labor participation in management under the Act).

sible to address all contingencies in a written contract. Even if employers identify certain contingences, they are not able to provide for them in the employment agreement due to high drafting costs.

It could be argued that the lifetime employment system creates a self-enforcement device for these implicit employment contracts. The employer's implicit promise not to dismiss employees until they reach retirement age will create a unique corporate culture emphasizing management's close ties with employees, which in turn will restrict the employer's opportunism.[123] The corporate culture functions as a device by which a firm communicates to its employees a message about how the firm will react to anticipated contingencies in employer-employee relationships.[124] The court's restrictions on dismissal[125] have further accelerated the implicit practice of the lifetime employment system.

This understanding may indeed explain the interaction between Japanese corporate governance and employment contracts. This article, however, takes a broader view of the relationship between the corporate structure and the relational practice. The lifetime employment practice is not only a signal used by employees to verify the reliability of the employer-firm, but it is also one of the primary reputation signals which a firm will rely on to verify the reliability of its potential transaction partner. A firm that is sensitive to its reputation is likely to develop a corporate culture emphasizing a social stability in which an enduring employer-employee relationship is one of the most important components. When a corporate culture becomes a general standard in a society, that culture becomes a reputation signal. A firm that adopts the lifetime employment system will earn a good reputation. If a firm lays off employees in a time of financial distress, the corporate culture will tarnish. Such tarnished corporate culture will negatively impact not only the firm's future opportunity to employ tal-

[123] *See* Milhaupt, *supra* note 12, at 27-28.

[124] *See id.*

[125] *See, e.g.*, Shioda v. Kōchi Broad. Co., 268 Rōdō Hanrei 17 (Sup. Ct., Jan. 31, 1977); Tokyo Oxygen Gas Co. v. Shimazaki, 30 Rōminshū 1002 (Tokyo High Ct., Oct. 29, 1979); Sanyo Elec. Co. v. Ikeda, 558 Rōdō Hanrei 45 (Osaka Dist. Ct., Feb. 20, 1990); Ishiguro v. Nippon Stainless Steel Co., 485 Rōdō Hanrei 43 (Niigata Dist. Ct., Takada Branch, Oct. 1986); Aiko v. Nissan Motor Co., 38 Rōminshū 681 (Tokyo High Ct., Dec. 24, 1987).

ented persons, but also the firm's flexibility in creating new transaction relationships in general.

Gilson hypothesizes that under the *nenkō* system, an individual in a firm is compelled to deal with the same individuals in other firms throughout his entire professional career, and a businessperson, who is supposed to have dealt with particular individual counterparts, will refrain from acting opportunistically, since such opportunistic conduct will hurt his chances for promotion.[126] If a firm emphasizes long-term relationships with clients, it is desirable that one manager continue to be engaged in the relationship. Even if managers are replaced periodically by a job rotation system, the former manager will move to a higher position within the firm that enables him to monitor the succeeding manager.[127] Indeed, the president of a company (*shachō*) is monitored by his predecessor who usually becomes chairman of the board of directors (*kaichō*) or the company advisor (*komon*) after his retirement from the presidency. Thus, the lifetime employment system has greater appeal for firms that want to develop long-term relationships with clients.

Japanese employees are given strong incentives to develop relation-specific skills; creating and maintaining long-term relationships with clients is one of the most important goals common to Japanese employees. Suppose that an employee of a firm adopting the lifetime employment system has two options when he procures raw materials to be used over an extended period: he can procure on a spot basis from different suppliers from time to time, or he can enter into a long-term procurement contract with one particular supplier. Assume also that, due to a volume discount, the price is lower if he chooses the long-term contract, but relation-specific skills and investments add costs to this option as well. If, in the aggregate, the two options have the same value, he may choose the long-term contract, which will give him the chance to achieve relation-specific results that will put him in a superior position under

[126] Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 309(1984).

[127] For example, a businessperson in a Japanese trading company (*sōgō-shōsha*) is expected to deal with a single commodity during his or her career as an employee of the trading company, since each employee is expected to develop a strong connection with a particular industry and strong expertise in the commodity that he deals with.

the firms' procurement operations. The manager will be honored as a pioneer of the long-term transaction. The problem, however, is that due to agency costs (namely, that the employee's real motivation is his promotion rather than profit maximization), employees may choose the long-term contract option even if it does not benefit the firm. If employees believe that creating long-term relationships will improve their chances of promotion under the lifetime employment system, every employee and manager will be eager to create long-lasting relationships, and their successors will be likely to preserve them.

In sum, the lifetime employment system emerges as a result of a society's preference for business stability. If the lifetime employment system is one of the institutions that encourages employees to create long-term relationships, a firm may want to verify its potential partner's level of reciprocity or fairness according to whether it adopts the lifetime employment system. Japanese firms adopt a company policy (lifetime employment) that places special emphasis on relational solutions to contingencies, and that policy in turn leads employees to believe that developing long-term relationships will contribute to profit maximization. If employees who create and maintain long-term relationships with clients are valued by firms, then they will be willing to stay at one firm and pursue this goal.

D. *Summary*

The traditional explanations of the interrelation between Japanese corporate governance and relational contract practice are unrealistic or, at best, explain only a fraction of Japanese business relationships. While the traditional literature has tried to explain the rationality of banks' inflexible contract practice, those explanations were not perfect. One might suggest that a bank does not need covenants because the main bank's exclusive monitoring mechanisms significantly reduce monitoring costs. However, it is unrealistic to assume that a monitoring function is exclusively delegated to a main bank. The hypothesis that banks monitor firms by threatening to punish the management of failing firms also lacks sufficient economic justification. One could also argue that a bank's threat to intervene in firm management prevents employees from shirking. However, it is unrealistic to suppose that banks will effectively observe the activities of employees. Rather, employees are likely to shirk, knowing that banks will rescue a failing firm in the end.

In the realm of inter-firm transactions, *keiretsu* cross-shareholding may act as a hostage for inter-keiretsu transactions. However, once transactions are conducted with non-*keiretsu,* cross-shareholding no longer functions as a self-enforcing device. Some may argue that a consensual decision-making process among *keiretsu* members in fact constrains managerial intervention by a main bank at the interim monitoring stage, but this theory would only hold for transactions among larger firms of former *zaibatsu* groups such as Mitsubishi and Mitsui.

Why did the uniquely Japanese relational contract practice persist? The logical answer to this question is that firms simply could not write complex contract terms even if they wanted to do so. If parties are unable to create new contract formulations and develop a discrete contract practice, they will seek an alternative self-enforcing mechanism. Repeated deals may function as a self-enforcement mechanism, but firms often encounter difficulty verifying one another because they must predict the reliability of future officers rather than current officers. Thus, firms seek business partners that can clearly demonstrate that they possess organizational stability. The more stable an organization, the more stable its management policy will be. A stable management policy suggests that future management will act with the same level of reciprocity and fairness as the current management has. Corporate governance is structured to fit with this stability requirement. A *keiretsu* cross-shareholding mechanism is a signal that each *keiretsu* firm has a stable management policy and a reciprocally fair transaction practice. Lifetime employment is one particular form of corporate culture which can constitute an integral part of a firm's reputation. A firm adopting lifetime employment policies signals to outside firms that it values reciprocal fairness and structural stability. When firms are equipped with these institutions, they earn a good reputation.

III.
Conclusion

Japanese corporate governance and relational contract practice are interrelated. Many scholars have argued that Japan's unique corporate governance structure contributed to its economic success after World War II, emphasizing that the Japanese relational contract practice was an efficient result of such unique structures. These arguments, however, lack sufficient theoretical and empirical grounds. This article examines the dynamics of the interaction of governance and contracting, and suggests that: (i) although in theory, contract practice in business-to-business transactions will ultimately evolve from relational to discrete, Japan's contract practice did not evolve as such due to the high drafting cost problem; (ii) relational practice was too fragile by nature to dominate contract practice, and thus it required the support of institutions that could function as self-enforcing devices; (iii) the traditional argument that the Japanese corporate structure functions as a firm-specific exchange of assets explains only a part of its institutional function in the relational contract regime; (iv) the Japanese corporate structure also has functioned as a reputation signal, conveying information about a particular firm's level of reciprocity and fairness. Japanese corporate governance was formulated in response to a strong preference for the kind of structural stability which relational contract practice demands, and was ultimately sublimated to function as a reputation signal.

The above explanation of the interaction between corporate governance and relational corporate practice suggests that the scarcity of business lawyers was at least one of the preconditions to Japanese corporate governance paving its own way. Presumably then, Japanese corporate structure will move to the stage of global convergence only when infrastructures are developed to provide business lawyers with legal planning and contract writing skills.