

# **The Olympus Scandal and Corporate Governance Reform: Can Japan Find a Middle Ground between the Board Monitoring Model and Management Model?**

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## I. INTRODUCTION

Japan has been in a corporate governance dilemma for the past 15 years. The country has been open to the idea of corporate governance reform following the collapse of its economic bubble in the early 1990s and has looked to the U.S. for inspiration. However, Japan has been caught between its traditional model of a board of directors that actively manages the corporation (the “management model”) and the American model of a board that focuses on the monitoring and supervision of management (the “monitoring model”).

This Article argues that it should be possible for Japan to find a middle ground between the management model and the monitoring model, which would incorporate a

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greater element of management monitoring into Japan's traditional corporate structure. The aftermath of the Olympus scandal provides an opportunity to make substantial progress towards that goal.

The Olympus case is particularly significant for two reasons. First, it follows on the heels of two tough years for Japanese corporate governance. In 2010, Toyota's slow response to car recall issues raised governance concerns about Japan's most highly-respected company.<sup>1</sup> The Great Eastern Earthquake of 11 March 2011 cast a harsh light on Tokyo Electric Power Company's (TEPCO's) preparedness and decision making, as the earthquake bankrupted what was formerly Japan's financially strongest company.<sup>2</sup> Furthermore, in late 2011, around the same time the Olympus scandal unfolded, a former chairman (and founding family member) at Daio Paper Company personally borrowed \$140 million from company subsidiaries to pay off gambling debts.<sup>3</sup> And in 2012, Japan suffered its own version of a Bernie Madoff-type scandal, as disastrous investments and a Ponzi scheme at AIJ Investment Advisors, an asset management company, resulted in a nearly total loss of the \$2.62 billion under management for its 123 corporate pension fund clients.<sup>4</sup>

Second, the Olympus case is reminiscent of the Enron scandal, not only because it occurred at a respected and innovative company, but also because it calls into question the functioning of fundamental aspects of Japan's corporate governance system. Olympus had no obvious weakness in its business model or corporate governance structure. It had transformed from a declining camera maker to a highly successful global competitor in medical devices (with a 70% share in the global market for endoscopes) that was presumably subject to product market discipline. And, in a country

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- 1 See, e.g., B. E. ARONSON, *Learning from Toyota's Troubles: Board Oversight, Board Structure, and Corporate Scandals in Japan*, ZJAPANR / J.JAPAN.L 30 (2010) 67.
  - 2 A comprehensive investigation by the Japanese Diet (parliament) faulted the Tokyo Electric Power Company (TEPCO), regulators and the government for lax governance and collusion. For an executive summary of the report in English, see generally THE NAT'L DIET OF JAPAN, *The Official Report of the Fukushima Nuclear Accident Independent Investigation Commission, Executive Summary* (2012), [http://naaic.go.jp/wp-content/uploads/2012/07/NAIIC\\_report\\_lo\\_res2.pdf](http://naaic.go.jp/wp-content/uploads/2012/07/NAIIC_report_lo_res2.pdf). One of the report's findings was that "TEPCO must undergo dramatic corporate reform, including governance and risk management and information disclosure – with safety as the sole priority." *Id.* at 23.
  - 3 The former chairman, Motohiko Ikawa, was the third member of the founding family to head the company, after his father and grandfather. Company officials immediately complied with his orders to company subsidiaries to send money to his personal account and to his account with casino operator Las Vegas Sands. The company is now trying to recover the loans. See, e.g., H. TABUCHI, *Another Scandal Unsettles Corporate Japan as Paper Maker Accuses Ex-Chairman*, N.Y. Times, 28 October 2011, <http://www.nytimes.com/2011/10/29/business/global/new-scandal-presses-corporate-japan.html>.
  - 4 See, e.g., H. TABUCHI, *Money Fund in Japan Told to Halt Operations*, N.Y. Times, 12 February 2012, <http://www.nytimes.com/2012/02/25/business/global/japan-orders-aij-investment-advisors-to-suspend-operations.html>.

where only half of listed companies have any outside directors, three out of fifteen of Olympus' directors were outsiders.<sup>5</sup> Yet, like Enron, the presence of a relatively high number of outside directors compared to other companies was ineffective in preventing extensive wrongdoing and severe financial consequences.<sup>6</sup>

This article argues that reformers should pay closer attention to reform proposals and ongoing experimentation at leading Japanese companies that attempt to develop a mixed or "hybrid" governance system. A hybrid system combines some of the traditional strengths of Japanese companies with a more robust monitoring component by linking the information access of insiders and the independence of a limited number of outsiders. The development and spread of such a model among Japanese companies could be accomplished through means such as the establishment of a corporate code of best practice combined with a "comply or explain" requirement for listed companies. Such spreading of best practices would represent a significant improvement in Japan's corporate governance system and could be achieved without focusing exclusively on the structural issue of building up the number of independent directors.

## II. THE OLYMPUS SCANDAL AND CORPORATE GOVERNANCE ISSUES

The Olympus case is possibly the worst corporate governance debacle of modern Japan.<sup>7</sup> Top management at Olympus concealed losses amounting to more than \$1.5 billion

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5 See, e.g., *Olympian Depths*, *Economist*, 3 November 2012, <http://www.economist.com/news/leaders/21565626-want-invest-underperforming-companies-no-outside-directors-go-japan-olympian>.

6 Deliberate fraud by management at Olympus led to some comments by industry representatives that the Olympus case represents an outlier with no general significance for Japanese corporate governance. A typical example is a quote from an official of the Japan Association of Corporate Executives (JACE) stating that "The Japanese economy will lose its international competitiveness if strict regulation is implemented as a result of generalizations based on a few bad apples." A. FENSOM, *After Olympus, Can Japan Inc Reform?*, *The Diplomat*, 5 July 2012, <http://thediplomat.com/2012/07/05/after-olympus-can-japan-inc-reform>. In an interview with the *Financial Times*, Japan's Prime Minister similarly stated, "I would not like the rest of the world to lump Olympus together with Japanese companies in general." See M. NAKAMOTO/M. DICKIE, *Japan PM Calls for Clarity on Olympus Scandal*, *Fin. Times*, 31 October 2011, <http://www.ft.com/intl/cms/s/0/1b7f24e2-031e-11e1-b7be-00144feabdc0.html#axzz28gJfF8nm>.

7 The Olympus scandal was particularly troubling because it occurred after two prior accounting scandals at Yamaichi Securities, see *infra* note 12 and accompanying text, and Kanebo Corporation and Livedoor Corporation, see *infra* notes 16 and 17 and accompanying text, that had resulted in substantial changes in the relevant law, accounting standards, and (presumably) corporate practices. In addition, as noted *supra* in the Introduction, Olympus was widely thought to be a successful company and an unlikely candidate for a corporate governance scandal.

dollars for over 20 years through three company presidents, utilized complex schemes to avoid changes in accounting standards, filed inaccurate securities reports for five years, and failed to provide basic information to its own board of directors. The Olympus scandal highlights a host of serious issues in current Japanese corporate governance practices (see Table 1).

*Table 1. Summary of the Olympus Case and Corporate Governance Issues*

| Olympus Issue  | Corporate Governance Problem   |
|--|--|
| Loss of \$1.5 billion<br>Loss of over 50% of stock market value  | Shareholder losses and lack of confidence in public securities markets               |
| Losses concealed over 20 years through the terms of three company presidents                               | CEO's practical ability to select successor CEO and company directors                |
| Utilization of complex schemes to evade new accounting standards   | Role of financial advisers and their regulation                                      |
| Filing of false securities reports<br>Change of accountants when questionable transactions were challenged | Role of outside audit firms and their regulation; role of internal company auditors  |
| No information to board of directors; no oversight by board  | Board functioning and role of independent directors; internal sharing of information |

The Olympus story begins with typical problems faced by Japanese manufacturers in the mid-1980s. These manufacturers, including Olympus, sought to combat a strengthening yen and to maintain their profits by more aggressive financial management of their assets.<sup>8</sup> This “financial engineering”<sup>9</sup> (*zaitech*) generally proved to be unsuccessful, and caused dramatic losses after the collapse of Japan’s economic bubble in the early 1990s.

The most comprehensive source of factual information on the problems and schemes at Olympus are the reports by independent third-party committees appointed by Olympus after the scandal became public. For an English translation of the most important of these reports, which is 243 pages including appendices, see OLYMPUS CORPORATION THIRD PARTY COMMITTEE, Investigation Report, Dec. 6, 2011 [hereinafter “Investigation Report”], available at <http://www.olympus-global.com/en/info/2011b/if111206corpe2.pdf>. For a convenient summary of this report, which is 33 pages including appendices, see OLYMPUS CORPORATION THIRD PARTY COMMITTEE, Investigation Report Summary, 6 December 2011 [hereinafter “Investigation Report Summary”], available at <http://www.olympus-global.com/en/info/2011b/if111206corpe.pdf>. Both of these reports are used extensively in this section. For other committee reports, see *infra* notes 21 and 39.

<sup>8</sup> See, e.g., Investigation Report Summary, *supra* note 7, at 6.

<sup>9</sup> *Id.*

A few companies obtained compensation for their losses from the securities companies that handled their investments.<sup>10</sup> However, many other Japanese businesses simply delayed recognizing losses, often through window dressing of accounts (*tobashi* or “flying away”)<sup>11</sup> so that bad assets were shuffled among entities without ever having to disclose losses. Such practices led to the dramatic failure of Yamaichi Securities, one of the Big Four Japanese securities companies, in 1997.<sup>12</sup> This event helped trigger both a financial crisis and a significant change in accounting standards in 2000 to require the periodic valuation of assets at market value and disclosure of losses.<sup>13</sup>

Instead of disclosing its losses and strengthening its finances, Olympus’ response to the new accounting standards was to devise and implement a complex scheme, with the help of outside financial advisers, to remove the bad assets from the balance sheet of Olympus without recognizing the losses. To accomplish this goal Olympus set up new entities under its control and sold the bad assets to these entities at inflated prices (the

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10 Compensation for losses was obtained by some preferred customers in the case of discretionary accounts. When this became a big issue in the early 1990s, the Ministry of Finance failed to crack down in cases where there was no contractual obligation and loss compensation was “voluntary.” See generally M. MISAWA, *Loss Compensation in the Japanese Securities Market: Causes, Significance, and Search for a Remedy*, Vand J. Transnat’l L. 25 (1992–1993) 37. This government position, which was intended to avoid liability by securities companies, perversely acted to weaken them instead and loss compensation issues continued. *Id.*

11 This practice was known by a number of phrases in English, including “shuffling” of assets. See Yamaichi Chief Gives Diet Testimony on Tobashi Trades, Japan Times, 9 December 1997, <http://www.japantimes.co.jp/text/nm19971209a2.html>. It often involved the “sale” of loss-carrying securities from one entity to another near the end of an accounting period so that it would not need to appear in the “seller’s” financial statements. *Id.* It might be “resold” back to the original “seller” at the beginning of a new accounting period or held by an affiliated entity. In either case unrecognized losses could continue to mount, as happened in the case of Olympus. See Investigation Report, *supra* note 7, at 11.

12 Although Yamaichi had sufficient capital to cover its concealed losses of some \$1.38 billion, its main lender, Fuji Bank, refused to continue providing unsecured funds for its daily operations. This liquidity crunch resulted in the biggest bankruptcy in Japan to date. S. STROM, *Big Japanese Securities Firm Falls, Putting the System on Trial*, N.Y. Times, 24 November 1997, <http://www.nytimes.com/1997/11/24/world/big-japanese-securities-firm-falls-putting-the-system-on-trial.html?pagewanted=all&src=pm>. The use of such *tobashi* window dressing in the Olympus case caused a number of media comparisons to the prior failure of Yamaichi Securities. See, e.g., M. YASU / N. FUJIMURA, *Olympus Urged to Extend Executive Purge Over Hidden Losses*, Bloomberg: Businessweek (Nov. 9, 2011), <http://www.businessweek.com/news/2011-11-09/olympus-urged-to-extend-executive-purge-over-hidden-losses.html>.

13 The accounting standard changed in 2000 from a historical cost basis standard to a “mark-to-market” standard under which any and all losses would be recognized for certain types of assets at the end of each accounting period. See, e.g., Investigation Report, *supra* note 7, at 13–14.

assets' original cost) to continue concealment of the losses.<sup>14</sup> Olympus also provided the money, either directly or indirectly, to enable the related entities to purchase the bad assets.<sup>15</sup> As a result, Olympus did not account for any loss on these "sales" and the bad assets no longer appeared in Olympus' financial statements.

However, a further change in accounting standards following scandals at Kanebo Corporation in 2005<sup>16</sup> and Livedoor Corporation in 2006<sup>17</sup> forced related entities to consolidate their financial statements beginning in 2007. Olympus responded by initiating the second phase of its concealment scheme, which was again devised by outside financial advisers.<sup>18</sup> The company paid grossly inflated prices and advisers' fees in M&A transactions for three Japanese companies, and later for a British company, Gyrus plc., and the inflated portion flowed back to repay Olympus for previously-provided financing and to cover accumulated losses.<sup>19</sup> When Olympus' outside accountants objected to the domestic transactions,<sup>20</sup> Olympus replaced its outside accounting firm, KPMG AZSA LLC with a new one, Ernst & Young ShinNihon LLC.<sup>21</sup>

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14 Investigation Report Summary, *supra* note 7, at 7–8

15 Olympus indirectly provided financing to the separate entities by arranging for bank loans that were collateralized by Olympus' holdings of Japanese government securities. It also directly provided investment funds to the related entities. *Id.* at 8–9.

16 For a discussion of the Kanebo case, see generally S. NUMATA / F. TAKEDA, Stock Market Reactions to Audit Failure in Japan: The Case of Kanebo and Chuoayama, *Int'l J. of Acct.* 45 (2009) 175.

17 See Livedoor: Melting Down: Arrests in the Livedoor Scandal, *Economist*, 26 January 2006, <http://www.economist.com/node/5444987>. For a longer treatment by a former director of Livedoor, see SHIRO YAMADA, Livedoor and a New Wave in Japanese Corporate Governance (Judge Business School, University of Cambridge, Sept. 1, 2006), [http://y-46.com/files/Livedoor\\_and\\_a\\_NewWave\\_in\\_Japanese\\_Corporate\\_Governance.pdf](http://y-46.com/files/Livedoor_and_a_NewWave_in_Japanese_Corporate_Governance.pdf).

18 See Investigation Report Summary, *supra* note 7, at 11–12. The Investigation Report refers to the first phase of Olympus' scheme as the "loss separation scheme" and the second phase as the "loss disposition scheme."

19 In accounting terms, the inflated premium would be booked as goodwill, which could be written off gradually without any large reduction in assets or capital on Olympus' books. See *id.* at 11.

20 Olympus' outside accounting firm objected to the large amount of goodwill booked in relation to the price paid for the three domestic companies. As a result, a substantial portion of the goodwill was written off immediately as an impaired loss. The Gyrus transaction involved similar issues about the size of goodwill in relation to the purchase price. See *id.* at 13–14.

21 Both accounting firms reportedly complied with the formal requirements for a change of auditor. However, it is questionable whether the succeeding audit firm fully understood and appreciated the concerns of the previous audit firm. The successor accounting firm, Ernst & Young ShinNihon LLC, also commissioned its own independent panel in December 2011, following questions raised by the release of the Investigation Report (*supra* note 7) on 6 December 2011. The Ernst & Young panel found no legal liability but recommended that accounting firms should go beyond their legal obligations in order to detect fraud. See K. INAGAKI, Panel Clears Ernst & Young in Olympus Probe, *Wall St. J.*, 29 March 2012,

Throughout this period the main business of Olympus was quite profitable, having successfully switched from cameras to a new business utilizing its imaging technology in medical devices.<sup>22</sup> All of the accounting problems stemmed from a small office in Olympus' Finance Department that was responsible for investments,<sup>23</sup> and the three successive presidents who oversaw the concealment of losses all came from that office rather than from the company's main business. No information on the losses was ever disclosed to the board of directors, and management generally discouraged employees from providing information on questionable company practices.<sup>24</sup>

Having apparently completed its scheme and now freed of its long-concealed losses, Olympus felt safe enough to tap an outsider, in fact a foreigner, as president in April, 2011. It chose a 30-year employee from England, Michael Woodford.<sup>25</sup> Prior management remained, and the incumbent Japanese chairman continued as the company's CEO.<sup>26</sup>

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*<http://online.wsj.com/article/SB10001424052702304177104577311121349992712.html>.*

Olympus' subsequent independent panel on auditor liability discovered numerous problems but did not find liability for either of the outside accounting firms. See OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, Investigation Report Summary (20 January 2012), at 20–26, *[http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120117\\_4.pdf](http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120117_4.pdf)*. For the full report, see OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, Investigation Report (16 January 2012), *[http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120117\\_5.pdf](http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120117_5.pdf)*.

However, Japan's Financial Services Agency ("FSA") subsequently issued a business improvement order to both accounting firms for failure to recognize the risks at Olympus and poor communication during the change of accountants. See Jiji Press, 2 Olympus Auditors Ordered to Improve, *The Daily Yomiuri*, July 7, 2012, *<http://www.yomiuri.co.jp/dy/national/T120706004637.htm>*.

22 Olympus is the world leader in endoscopes, with a 70 percent share of the global market. See T. AMANO / M. YASU, Sony to Buy Olympus Stake as Hirai Seeks Revival From Losses, *Bloomberg: Businessweek* (Sept. 28, 2012), *<http://www.businessweek.com/news/2012-09-28/olympus-s-directors-approve-sony-tie-up-plan-official-says>*.

23 See Investigation Report, *supra* note 7, at 8–11.

24 Japanese companies and other organizations generally have an internal disclosure system (*naibu tshō seido*) or company hotline for employees to provide information on questionable activities. This is based on Japan's Whistleblower Protection Act (Law No. 122 of 2004), an English version of which is available at *<http://www.cas.go.jp/jp/seisaku/hourei/data/WPA.pdf>*. For an introduction to this law, see L. WOLFF, New Whistleblower Protection Laws for Japan, *ZJAPANR / J.JAPANL.* 17 (2004) 209, available at *[http://sydney.edu.au/law/anjel/documents/ZJapanR/ZJapanR\\_17\\_19\\_Wolff.pdf](http://sydney.edu.au/law/anjel/documents/ZJapanR/ZJapanR_17_19_Wolff.pdf)*.

The Investigation Report refers to Olympus' internal disclosure system (referring to it as an internal "Compliance Help Line") and criticizes it as having a "closed nature." See Investigation Report, *supra* note 7, at 128.

25 See J. SOBLE, Ex-Olympus Chief Questioned Payments, *Fin. Times*, 14 October 2011, *<http://www.ft.com/intl/cms/s/2/87cbfc42-f612-11e0-bcc2-00144feab49a.html#axzz1b4gXJ8p>*. This article, based on an interview with Woodford, ascribes Woodford's hiring to Olympus' desire for a foreign president who would focus on undertaking painful restructuring mea-

However, in August and again in October of 2011 a small, independent magazine called Facta published embarrassing articles on Olympus' large losses on its recent acquisitions.<sup>27</sup> Insiders at Olympus downplayed the story, but Woodford retained PricewaterhouseCoopers (PwC) in London to examine adviser fees paid for the Gyrus acquisition in England. PwC's interim report concluded that there were significant defects in Olympus' governance on matters such as its due diligence and decision-making procedures. On October 11, 2011 Woodford sent a 13-page letter demanding the resignation of the entire board, citing "serious governance concerns" and attaching the PwC report.<sup>28</sup> At a special meeting of the board on October 14, 2011, Woodford was fired as President for alleged problems with his "management style" in a meeting that lasted minutes.<sup>29</sup>

Woodford then broke the story to the Financial Times and contacted law enforcement authorities in the U.K. and the U.S.<sup>30</sup> A week later the story finally appeared in the mainstream Japanese press.<sup>31</sup> After initially denying all of Woodward's accusations,

tures with respect to the faltering camera business without looking carefully at past "domestic" transactions that were questionable. *Id.*

26 Although Woodford was appointed president in April 2011, he was not immediately made CEO. Later, as problems began to arise and Woodford pushed for answers, he was made CEO at a board meeting on 30 September 2011. See Investigation Report, *supra* note 7, at 177. However, he was fired two weeks later. See *infra* notes 29–30 and accompanying text.

27 See Investigation Report, *supra* note 7, at 176–78. Facta was able to act independently due to its reliance on subscribers rather than advertisers. The publisher, Shigeo Abe, regretted his past experience at Japan's leading business daily, where outside pressures had prevented early publication of an important scandal (see *supra* note 12 and accompanying text) involving Yamaichi Securities. See D. MCNEILL, Stop the Presses and Hold the Front Page, Japan Times, 8 January 2012, <http://www.japantimes.co.jp/print/fl20120108x1.html>. Not only was the Olympus story not picked up by the mainstream Japanese press, Facta's publisher was also worried that Olympus would sue his small magazine for defamation and possibly put him out of business. Remarks by SHIGEO ABE, Publisher of Facta, at *Kinkyū tōron: orinpasu jiken, nihon wa nani o manabu beki ka* [Emergency Discussion: The Olympus Scandal, What Should Japan Learn?] *Shagai Netto Seminā* [Outside Director Network Seminar], Tokyo, 20 December 2011.

For an overview of events from Woodford's perspective see K.T. GREENFIELD, The Story Behind the Olympus Scandal, Bloomberg: Businessweek, Feb. 16, 2012, <http://www.businessweek.com/articles/2012-02-16/the-story-behind-the-olympus-scandal>. Woodward has also written a book based on his experience. See M. WOODFORD, *Exposure: Inside the Olympus Scandal: How I Went from CEO to Whistleblower* (2012).

28 *Id.* See also Letter from Michael Woodford, President and CEO, Olympus Corporation, to Tsuyoshi Kikukawa, Chairman, Olympus Corporation (Oct. 11, 2011), available at <http://www.offshorealert.com/GetDocument.aspx?id=4177>

29 See GREENFIELD, *supra* note 27; Investigation Report, *supra* note 7, at 177.

30 See J. SOBLE, Ex-Olympus Chief Questioned Payments, Fin. Times, 14 October 2011, <http://www.ft.com/intl/cms/s/2/87cbfc42-f612-11e0-bcc2-00144feab49a.html#axzz1b4gzXJ8p>.

31 Following Woodford's dismissal, the Japanese press initially echoed the viewpoint of Olympus' management about Woodford's supposedly problematic management style. How-

Olympus' top management admitted hiding losses and resigned in November 2011.<sup>32</sup> Woodford initially spoke of trying to regain control of Olympus, but was discouraged by Japanese institutional investors' continuing support for the current management.<sup>33</sup>

Once the true story came to light, Olympus's stock value dropped by nearly 80%.<sup>34</sup> The company restated the last five years of financial statements and submitted them to the Tokyo Stock Exchange ("TSE") on December 14, 2011, just in time to avoid being delisted.<sup>35</sup> Later, the TSE levied its maximum fine, a mere \$100,000, on Olympus.<sup>36</sup>

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ever, within weeks the Japanese press began to cover allegations of wrongdoing at Olympus. See, e.g., J. ADELSTEIN, Japan's Olympus Scandal is Slowly Coming Into Focus, *Guardian*, 3 November 2011, <http://www.guardian.co.uk/commentisfree/2011/nov/03/japan-olympus-scandal>.

32 See, e.g., P. DVORAK / D. WAKABAYASHI, Olympus Spurs More Questions than Answers, *Wall St. J.*, 8 November 2011; H. TABUCHI, 3 Olympus Executives Resign Ahead of Crucial Meeting, *N.Y. Times*, 24 November 2011.

33 There was no immediate clean sweep of Olympus' management following the revelations of wrongdoing. After Woodward's resignation in November 2011, the new president of Olympus was Shuichi Takayama, a long-time executive and board member who claimed he knew nothing about the scandal. Even when Olympus initiated litigation against current and former board members and corporate auditors, see *infra* note 44, it allowed those same individuals, including Mr. Takayama, to continue to manage the corporation. See H. TABUCHI, Olympus Sues Executives Over Coverup, but Does Not Dismiss Them, *N.Y. Times*, 10 January 2012, <http://www.nytimes.com/2012/01/11/business/global/olympus-sues-executives-over-cover-up.html>. This provoked howls from foreign institutional investors that Olympus was being managed by a "discredited board". *Id.* The entire board was eventually replaced at a special shareholders' meeting in April 2012. See *infra* note 41.

Foreign shareholders shared Woodford's concerns and issued statements of support. See K. INAGAKI, Foreign Shareholders Call for Return of Fired CEO, *Wall St. J.*, 11 November 2011. However, Japanese institutional shareholders continued to support Olympus' management, and Olympus' main bank, Sumitomo Mitsui Banking Corp. refused to meet with Woodward. See Woodford Gives Up Fight to Head Olympus, Will Sue (CNS News), <http://cnsnews.com/woodford-gives-fight-head-olympus-will-sue-1>. At a press conference on 6 January 2012 at the Japan National Press Club in Tokyo, Woodford stated that "[d]espite one of the biggest scandals in history, Japanese institutional investors have not spoken one single word of criticism, in complete and utter contrast to overseas shareholders who are demanding accountability from directors." *Id.*

34 See TABUCHI, *supra* note 33.

35 The third-party investigation committee found no evidence to support a report in the August 2011 *Facta* article (see *supra* note 27 and accompanying text) of Japanese organized crime involvement in the Olympus scandal. See Investigation Report Summary, *supra* note 7, at 17 (finding "no involvement" of such "anti-social forces" in the loss disposition plan). The absence of evidence concerning any such link presumably permitted Olympus to remain listed.

36 See, e.g., K. INAGAKI, TSE Keeps Olympus Listed, Imposes Fine, *Wall St. J.*, 20 January 2012, <http://online.wsj.com/article/SB10001424052970204616504577172171651245402.html>. (describing the maximum 10 million yen fine imposed on Olympus as "a maximum, if largely symbolic, fine ...").

Olympus commissioned a third-party investigation committee to examine the matter.<sup>37</sup> The committee released an extensive report in December, 2011 that discussed the schemes in detail and pronounced Olympus' management "rotten to the core."<sup>38</sup> The company then formed two additional third-party investigation committees to look at liability issues for directors and for auditors. These committees issued reports in January 2012.<sup>39</sup> Criminal investigations and civil lawsuits followed these disclosures (see Table 2).

Table 2. *Olympus' Internal Investigations and Litigation*<sup>40</sup>

| Olympus Internal Investigations and Findings   | Resulting External Investigations / Litigation |
|--|--|
| Third-party committee report, 6 December 2011:   | Criminal investigation                         |
| Accumulated losses due to management schemes; lack of effective corporate governance and internal control system | SESC securities investigation                  |
| Director liability investigation committee report, Jan. 10, 2012:  | Tokyo stock exchange—no delisting              |
| Lawsuit recommended against 19 former executives for \$208 million   | Shareholder litigation                         |

37 Olympus announced it would appoint a third-party committee on October 21, 2011 and announced the appointment of the committee on November 1, 2011. See OLYMPUS CORP., Notice Concerning the Establishment of a Third Party Committee (1 November 2012), <http://www.olympus-global.com/en/corc/ir/tes/pdf/nr111101.pdf>.

38 See Investigation Report Summary, *supra* note 7, at 23. The unofficial English translation on Olympus' website actually says, "The core of management was corrupted ..." However, many newspaper accounts used the more colorful (and equally accurate) phrase "rotten to the core." See, e.g., M. YASU / N. FUJIMURA, Olympus Report Clears Way for Clean Sweep of Board That Failed to Stop Rot, Bloomberg (Dec. 6, 2011), <http://www.bloomberg.com/news/2011-12-06/olympus-management-rotten-to-the-core-panel.html>.

39 See OLYMPUS CORPORATION DIRECTOR LIABILITY INVESTIGATION COMMITTEE, Investigation Report, 7 January 2012, [http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120110\\_2.pdf](http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120110_2.pdf); OLYMPUS CORPORATION NON-DIRECTOR MANAGEMENT LIABILITY COMMITTEE, Investigation Report, *supra* note 21.

40 Sources include: English versions of the committee reports commissioned by Olympus, *supra* notes 7, 21, and 39; *infra* note 43 (government investigations); *supra* notes 33, 35-36 (Tokyo Stock Exchange) *infra* note 44 (shareholder litigation); D. ROBINSON, Olympus Settles with Ex-chief Woodward, Fin. Times, 29 May 2012 (discussing Woodford litigation); *infra* note 44 (Olympus litigation against former directors and company auditors).

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| Non-director management liability investigation committee report, Jan. 17, 2012:                                       | Woodford employment litigation (settled by payment to Woodward)  |
| No liability for outside auditors; lawsuit recommended against five past and present company auditors for \$31 million | Olympus litigation against former directors and company auditors |

Olympus' plan to reform its corporate governance was implemented at an Extraordinary General Meeting of Shareholders on April 11, 2012.<sup>41</sup> The number of board members was reduced from 15 to 11, outside directors were made a majority of the board, and the top management was replaced.<sup>42</sup> Meanwhile, various government investigations by prosecutors, police and Japanese regulators are proceeding as of the date of publication of this Article.<sup>43</sup> There are still ongoing private lawsuits filed by Olympus against former directors and company auditors, as well as suits filed by shareholders.<sup>44</sup> Olympus is also planning to rebuild its capital, which was diminished when Olympus finally

41 See OLYMPUS CORP., Notice Concerning the Results of the Extraordinary Meeting of Shareholders (20 April 2012), <http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120420.pdf>.

42 See *id.* This reform plan was also criticized, as proxy adviser Institutional Shareholder Services recommended voting against the candidate for chairman and another candidate for director on the grounds that they had long careers as bank lenders to Olympus, and further recommended voting against the company's candidate for president due to his lack of high-level experience at the company. Olympus strongly objected to ISS' negative recommendations. See MICHIO NAKAMOTO, Olympus Rejects ISS Criticism of Proposals, *Fin Times*, 11 April 2012, <http://www.ft.com/intl/cms/s/0/e4eab54a-83b5-11e1-82ca-00144feab49a.html#axzz28gJfF8nm>.

43 Three former Olympus executives and the corporation have pleaded guilty to criminal charges. See, e.g., Olympus and Ex-Executives Plead Guilty in Accounting Fraud, *N.Y. Times*, 25 September 2012, [http://www.nytimes.com/2012/09/26/business/global/guilty-pleas-in-trial-over-olympus-scandal.html?\\_r=0](http://www.nytimes.com/2012/09/26/business/global/guilty-pleas-in-trial-over-olympus-scandal.html?_r=0).

44 Olympus filed lawsuits against 19 former and current directors and company auditors as recommended by the Olympus Corporation Director Liability Investigation Committee, Investigation Report, *supra* note 39, and the Olympus Corporation Non-Director Management Liability Committee, Investigation Report, *supra* note 21. For a description and the list of defendants, see OLYMPUS CORPORATION, Notice Concerning Measures Olympus Corporation Will Implement in Light of Commencement of Lawsuits against Directors and Corporate Auditors, 18 January 2012, <http://www.olympus-global.com/en/corc/ir/tes/pdf/nr120118.pdf>. See also TABUCHI, *supra* note 33. With respect to shareholder litigation in Japan against Olympus, see, e.g., H. OZAWA, Olympus Scandal Triggers Japan Shareholder Activism, *Yahoo! News*, 22 January 2012, <http://au.finance.yahoo.com/news/olympus-scandal-triggers-japan-shareholder-124237789.html>.

acknowledged and wrote off its long-concealed losses, through a new capital and business alliance with Sony Corporation.<sup>45</sup>

### III. TOWARDS A MIXED MODEL? CONSIDERING EFFECTIVE MONITORING OF MANAGEMENT UNDER THE JAPANESE CORPORATE GOVERNANCE SYSTEM

Foreign institutional investors and other corporate governance reformers have expressed great disappointment at the lack of quick, dramatic change in corporate governance rules in Japan in response to the Olympus scandal. However, despite failing to make clear progress on the most highly visible and divisive issues such as requiring outside/independent directors, many leading Japanese companies are nonetheless making interesting improvements in corporate governance. Although it is difficult for a large and diverse industry group to agree to new legal requirements, companies are experimenting with new ways to improve corporate governance, and are moving to develop mixed or hybrid systems that they hope will act to combine the best elements of the board management and monitoring models.

The goal of this hybrid approach is to form a system that combines the information access of insiders with the independence of outsiders in a way that results in real board discussion and management oversight. This has been an ongoing topic for some time and was highlighted in an FSA report on corporate governance in 2009 that emphasized the possibility.<sup>46</sup> There are currently three government advisory councils (in the Ministry

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45 Olympus is looking for a capital infusion of some 50 billion yen (roughly \$640 million) before the end of the fiscal year in March 2013 to help make up its \$1.5 billion concealed losses, low shareholder equity, and continuing losses in the camera business. See, e.g., J. OSAWA / K. INAGAKI, Olympus, Sony Tie Up, Wall St. J., 28 September 2012, <http://online.wsj.com/article/SB10000872396390444712904578023743949186694.html>. Following implementation of the agreement with Sony, Sony will become Olympus' largest shareholder with 11.5 percent of voting shares. *Id.* See also Press Release, Olympus Corp. and Sony Corp., Announcement of Agreements Between Olympus and Sony to Form Business and Capital Alliance (28 September 2012), <http://www.sony.net/SonyInfo/News/Press/201209/12-0928E/index.html>.

46 The FSA report noted the idea that the governance at traditional companies with auditors might be strengthened by company auditors cooperating with a limited number of outside directors. These outside directors would also cooperate with the corporate departments responsible for internal controls and audit to form a corporate governance structure with greater appeal to foreign institutional investors than the company with auditors structure. See generally FINANCIAL SERVICES AGENCY, Report by the Financial System Council's Study Group on the Internationalization of Japanese Financial and Capital Markets: Toward Stronger Corporate Governance of Publicly Listed Companies (17 June 2009), <http://www.fsa.go.jp/en/news/2009/20090618-1/01.pdf>. See also ZADANKAI, *Jōjō gaisho o meguru kaisei to waga-kuni no kōporeeto gabanansu* [Panel Discussion: Amendments for Listed Companies and Japanese Corporate Governance] Shōji Hōmu 1879 (2009) 16. Although the discussion began, in part,

of Justice or MOJ, the FSA, and the Ministry of Economy Trade and Industry or METI) and a number of private study groups that are wrestling with proposals to improve Japanese corporate governance.<sup>47</sup> The hybrid approach remains a subject of active discussion at METI's ongoing deliberations.<sup>48</sup> In addition, the MOJ study group proposed in its draft amendments to the Companies Act a new "one-committee" system, i.e. a "company with audit & supervisory committee" system, in which company auditors would be replaced by (or essentially "upgraded" to) an audit committee of the board.<sup>49</sup> This represents one effort at formalizing such a mixed approach. The goal of this proposal is to allow Japanese boards to retain some of their current management role and to add a clearer supervisory role.<sup>50</sup>

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as an attempt to justify a requirement of at least one outside director in addition to company auditors, it has since expanded to include more basic issues of corporate governance.

47 The most prominent governmental deliberative council is the relatively new Corporate Law Subcommittee of the Legislative Council within the MOJ, whose task is to propose changes to the Companies Act. With respect to the most controversial issue of requiring at least one outside director for listed companies, the Subcommittee's preliminary report, issued in December, 2011, was unable to reach a conclusion and merely listed three options for amending the Companies Act with respect to outside directors. *See infra* note 63. In its subsequent draft amendments issued in August 2012, the Subcommittee adopted a form of a "comply or explain provision," which would require a reporting company without any outside directors to explain its reason for the lack of outside directors; in an additional supplementary resolution, the Subcommittee also recommended that the TSE adopt a rule requiring at least one independent director for all listed companies.

See HÖMU-SHÖ, MINJI-KYOKU, SANJI KANSHITSU [Ministry Of Justice, Civil Affairs Bureau, Councilors' Office], *Kaisha hōsei no minaoshi ni kansuru yōkōan* [Draft Outline Of Amendments To The Companies Act], August 2012 [hereinafter "Draft Amendments"], <http://www.moj.go.jp/content/000100819.pdf>. The accompanying resolution on a new Tokyo Stock Exchange listing rule is available at [http://www.tse.or.jp/english/news/09/2012\\_0801\\_a.html](http://www.tse.or.jp/english/news/09/2012_0801_a.html).

48 One of the topics under discussion by the METI study group on corporate governance is the potential role of "non-executive directors" (*hi-gyōmu shikkō yakuin*), which include not only independent directors, but also directors with ties to the company who currently hold no executive position. For topics being covered by METI's current group, *Kōporeeto Gabanansu Shisutemu No Arikata Ni Kansuru Kenkyū-kai* [Study Group on the Form of Corporate Governance System], see [http://www.meti.go.jp/committee/kenkyukai/sansei/corporate\\_gov\\_sys/001\\_05\\_00.pdf](http://www.meti.go.jp/committee/kenkyukai/sansei/corporate_gov_sys/001_05_00.pdf). As of the date of writing this Article, this group has yet to release a report. Toshiba Corporation provides a good example of the use of such non-executive directors in practice. See *infra* note 71 and accompanying text.

49 See Draft Amendments, *supra* note 47.

50 See e.g., K. TAKEI, "*Kansa iinkai setchi kaisha*" no kaikin [Removal of Prohibition on "Company with Audit Committee"], *Shōji Hōmu* 1900 (2010) 13. The author notes that Japanese companies generally wish to retain a substantial management role for the board since they view a "hands-on" or "front line" management style (in Japanese "*genba shugi*" or literally "on-site ism") as an important method for Japan's high-ranking executives to contribute to the company, or (in the currently popular parlance) "add corporate value." *Id.* at 16. This proposed form looks closer to the company with auditors model than the com-

The effectiveness of internal corporate auditors (*kansayaku* or “company auditor”)<sup>51</sup> is a fundamental issue underlying this approach. They are criticized as lacking authority since they have no vote at board meetings and cannot hire or fire the CEO or directors.<sup>52</sup> In addition, they have historically been regarded as lifetime company employees who are not in a good position to question management and do not aggressively pursue their responsibilities.<sup>53</sup>

On the other hand, company auditors have some authority that directors do not, including a right of investigation (enabling them to obtain all relevant information) and the ability to obtain a court injunction against proposed illegal acts of the corporation.<sup>54</sup> They must attend board meetings and can voice their opinions;<sup>55</sup> over time their powers have increased and the qualifications, particularly of outside company auditors, have steadily improved.<sup>56</sup>

pany with committees model; however, it is relatively flexible and would hopefully, according to its proponents, satisfy the demands of foreign institutional investors for more independent directors without increasing the number of outsiders in top positions. *Id.* at 21. Whether it will satisfy foreign investors or have appeal for Japanese companies remains unknown. For the actual proposal on a company with an audit and a supervisory committee, see Draft Amendments, *supra* note 47.

51 There is no universally accepted English translation of *kansayaku*. This Article uses “company auditor” since that is the term used in a translation of Japan’s Companies Act, sponsored by the Ministry of Justice. English translations of rules and reports on the TSE use the term “statutory auditor,” and the industry association of *kansayaku* uses “corporate auditor.” No English term fully or accurately describes their function without further explanation.

52 See e.g., Asian Corporate Governance Association 18 (2008) [hereinafter ACGA White Paper], [http://www.acga-asia.org/public/files/Japan%20WP\\_%20May2008.pdf](http://www.acga-asia.org/public/files/Japan%20WP_%20May2008.pdf).

53 *Id.*

54 See *Kaisha-hō* [Companies Act], Law No. 86 of 2005 [hereinafter “Companies Act”], art. 381, ¶ 2 & art. 385, ¶ 1. For a summary of their role and authority, see the Japan Corporate Auditor Association’s website, <http://www.kansa.or.jp/en/about-corporate-auditor/about.html>. Also, see generally C.-C. LIN, The Japanese Independent Director Mechanism Revisited: The Corporate Law Setting, Current Status, and its Explanations, *Temp. Int’l & Comp. L. J.* 24 (2010) 65, 89.

55 See Companies Act, *supra* note 54, art. 383, ¶ 1.

56 However, company auditors generally do not use a number of the powers granted to them under the Companies Act, such as their power to report problems to shareholders. See TAKEI, *supra* note 50, at 17–18. More generally, a new outside company auditor noted in a confidential interview that if company auditors actually exercised all their legal powers regularly they could be in influential positions. However, in practice many company auditors do not normally voice their views at board meetings, but rather convey their opinions at separate meetings of the board of audit (comprised of all the company auditors), so that the inside company auditors can inform management. Interview (confidential), Tokyo (Oct. 15, 2012). On the other hand, an active outside company auditor can make a real difference in a company where directors do not generally voice opinions at board meetings. At such companies, meetings can take on the tone of a dialogue between the

The best way to consider this issue may be in terms of functional strengths and weaknesses. Company auditors are relatively effective on certain issues such as scrutinizing proposed transactions for accounting or legal issues. They are weaker, however, in the important areas of handling conflicts of interest and monitoring top management; these areas have not been emphasized in Japan to date.<sup>57</sup>

One Japanese commentator characterizes this fundamental issue as Japanese companies conflating the audit function of company auditors with the supervisory function that would normally be carried out by a supervisory board (in Germany) or the board of directors (in the U.S.).<sup>58</sup> Although Japanese law and practice may be strong in auditing individual transactions, it is weak in the oversight of formulation and implementation of the company's strategic plans, as well as in personnel and compensation issues related to directors and top management.<sup>59</sup>

In fact, the board's lack of supervision over the CEO, including matters such as hiring and firing, may be the biggest corporate governance problem at traditional Japanese corporations.<sup>60</sup> In a stakeholder system in which the CEO acts on behalf of all interested parties, and not just the shareholders, it is unclear to whom the CEO is accountable.<sup>61</sup> In theory, under Japanese law the directors supervise the representative

company president and the active outside company auditor. Interview with Shiro Kuniya, Esq., Managing Partner, Ohehashi LPC & Partners, Tokyo (3 February 2012).

57 The function of company auditors is characterized by the Asian Corporate Governance Association as a “quasi-compliance officer” who will take action only when the company is violating the law or a reporting standard and concludes that the position of company auditor “seldom provides for real, independent supervision of senior management decisions.” See ACGA White Paper, *supra* note 52, at 18. One interviewee characterized the Japanese and American corporate governance systems as comprising opposite extremes: the Japanese focus heavily on employees and compliance (and relatively little on monitoring of management) while Americans concentrate on supervising top management (and pay less attention to employees and compliance). Interview with Seiya Shimaoka, General Manager of the Legal Department, Toshiba Corporation, Tokyo (30 March 2012).

58 See K. ŌSUGI, *Torishimari yakukai no kantoku kinō no kyōka—Jō* [Strengthening the Supervisory Function of the Board of Directors—Part I], *Shōji Hōmu* 1941 (2011) 17.

59 *Id.* at 19. Although these problems are often ascribed to entrenched corporate practices in Japan, the law also plays a role. Professor Ōsugi notes that the Companies Act provision on matters to be decided by the board (art. 362, ¶ 4, Item 2) is both underinclusive and overinclusive – i.e., it includes some relatively minor matters, but also does not provide explicitly for the board to decide basic business strategy. Similarly, in the personnel area, the board formally votes to decide the president, but there is no provision on procedures, standards, or a succession plan. *Id.* at 19.

60 See, e.g., LIN *supra* note 54; N. TSUDA, *Mitsubishi kemikaru hōrudingu gurūpu no gabanansu to naibu tōsei* [Governance and Internal Controls of the Mitsubishi Chemical Holdings Group], Business Research Institute, Tokyo, 18 October 2012.

61 If the corporate purpose is to represent the interests of, and provide value to, all stakeholders, this can result in a concentration of power and discretion in the hands of management. This is one objection often cited by proponents of shareholder-oriented

director (i.e., CEO).<sup>62</sup> In reality however, directors are often selected by the individual they are expected to supervise. Thus, instead of the CEO being accountable to shareholders or a board of directors, the CEO is the person to whom the board is accountable.

It is here that independent directors can play a critical role. Even if they do not constitute a majority of the board, a group of independent directors can potentially be effective in the most fundamental role of monitoring self-dealing and top management, particularly if the necessary information can be obtained. In a “mixed” system independent directors are expected to cooperate with knowledgeable insiders, such as company auditors or the company’s internal audit and internal control departments, to be effective. This goes beyond the proposal for a single independent director, as has been discussed in recent corporate law reform efforts,<sup>63</sup> because it is unlikely that one independent director would feel comfortable or be effective as the sole voice to challenge management when necessary.<sup>64</sup> With respect to the question of how many independent directors would be necessary, the Asian Corporate Governance Association has proposed a minimum of three,<sup>65</sup> and other proposals utilize a similar approach as a starting point.<sup>66</sup>

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systems with respect to broader corporate goals regarding stakeholders and the public. See, e.g., H. HANSMANN / R. KRAAKMAN, *The End of History for Corporate Law*, *Geo. L.J.* 89 (2001) 439.

- 62 The board of directors has the authority and duty to monitor the executive acts of both directors and executives. *Companies Act*, *supra* note 54, art. 362, ¶ 2, Item 2. The board has the authority to remove the representative director from his position at any time. *Companies Act*, *supra* note 54, art. 363, ¶ 2, Item 3.
- 63 As noted *supra* note 47, the first preliminary report of MOJ’s committee, issued in December 2011, was unable to reach a conclusion with respect to the most controversial issue of requiring at least one outside director for listed companies and merely listed three options for amending the *Companies Act* with respect to outside directors. A possible requirement for one independent director was listed as one option. See HÖMU-SHŌ, MINJIKYOKU, SANJI KANSHITSU [Ministry Of Justice, Civil Affairs Bureau, Councilors’ Office], *Kaisha hōsei no minaoshi ni kansuru chūkan shian* [Interim Proposal Concerning Revisions Of Companies Act] (Dec. 2011), <http://www.moj.go.jp/content/000082647.pdf>. An English translation of this interim proposal is available at <http://www.tse.or.jp/english/news/09/b7gje600000tk7a-att/b7gje600000tkaj.pdf>.
- 64 For example, the Asian Corporate Governance Association bases its recommendations on the minimum number of independent directors for Japanese boards on “practical experience in other developed markets regarding the minimum number of independent directors required for the effective functioning of boards.” See ACGA White Paper, *supra* note 52, at 21.
- 65 See ACGA White Paper, *supra* note 52, at 21. Although this is their recommendation for immediate action, they expect the percentage of independent directors to rise to one-third in the medium term and one-half in the long term. *Id.* The chairman of the Corporate Governance Research Group, Meiji Institute for Global Affairs, stated that while three independent directors would be ideal, two independent directors would both represent substantial progress and be more achievable at this point in time. Comment by Sumitaka Fujita, Executive Director, CFO Association, former Vice Chairman of major trading company Itoh Chu, and Independent Director (as of April 2012), Olympus Corporation, in

This movement towards a mixed system is premised on the view of many leading Japanese companies that corporate governance functioning is of greater importance than board structure. Although relatively few companies have adopted the company with committees structure and the political debate is deadlocked, leading Japanese companies do not necessarily see corporate governance as a stark choice between adopting this new structure or retaining the traditional company with auditors form. In fact, some industry leaders see some functional or practical similarities in approaches by companies with different board structures due to modifications of both types of structures by Japanese companies to achieve desired results.<sup>67</sup>

For example, as noted *supra*, the most commonly-cited reason for the unpopularity of the company with committees structure is the role of the nomination committee in theoretically supplanting the president's prerogatives.<sup>68</sup> However, some companies with auditors have a process to screen the president's preferred choices to ensure they are based on the merits and not on cronyism. In fact, a number of these companies have established formal committees with outsiders for that purpose.<sup>69</sup> Such a process

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Response to Presentation by Bruce E. Aronson at Corporate Governance Research Group, Meiji Institute for Global Affairs, Tokyo (June 29, 2012).

- 66 See, e.g., NICHOLAS BENES, My Proposal for Company Law Reform in Japan: Ready To Be Dusted Off in Another Five Years, BDTI (1 December 2011), <http://bdti.or.jp/english/node/544> (proposing that public companies have the following choice: (1) appoint three independent directors who form an independent committee to make decisions on particular board matters, defined by statute, in which managers have a conflict or self-interest, or (2) failing that, in shareholder derivative litigation directors will be subject to a rebuttable presumption of liability for alleged damages once plaintiffs have established causation and damages).
- 67 See, e.g., Shimaoka, *supra* note 57. This is also reportedly the premise of many participants in the current METI study group. For a description of this study group, see *supra* note 48. See also J. BUCHANAN / S. DEAKIN, Japan's Paradoxical Response to the New 'Global Standard' in Corporate Governance, ZJAPANR / J.JAPAN.L. 26 (2008) 59 (finding in a series of interviews that reform at Japanese companies did not depend on corporate form, and that both companies with auditors and companies with committees were engaged in streamlining their decision-making processes), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1013286](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1013286).
- 68 Comments in Response to Presentation at 21st Century Managers Forum, Business Research Institute (25 September 2012).
- 69 Teijin Limited has established an advisory board and one of its functions is to select CEO candidates and to recommend them to the board of directors. See Corporate Governance Guide, Teijin, <http://www.teijin.co.jp/english/ir/governance/guide.html> (last visited 13 March 2013). The company president does not, "in principle," participate in committee discussions. *Id.* Teijin also has three independent directors in a board of up to 10 directors. Another variation is the example of Asahi Glass Co., Ltd., a company with auditors that has established a nomination committee and a compensation committee. The nomination committee currently consists of four directors, the president and three outside directors. See Corporate Governance, Asahi Glass Co., <http://www.agc.com/english/company/governance.html> (last visited 13 March 2013).

theoretically retains the president's prerogative, while giving some real monitoring power to outsiders.

At the same time, the actual work of nomination committees at "American-style" companies with committees may not be very different from that of the traditional companies with auditors that have formed nomination committees. The reported role of such "American-style" nomination committees is often similarly limited to vetting candidates chosen by management (the president or chairman) and they generally do not seek to independently identify and screen potential candidates.<sup>70</sup>

In fact, the small number of Japanese companies that have adopted the company with committee structure have more generally modified the system in practice to address Japanese circumstances. For example, Toshiba emphasizes an equal division of board members between executive directors and non-executive directors. A number of non-executive directors are valued as important former (well-informed) Toshiba officials who are senior to, and can more easily question, the current top management even though they do not qualify as outside directors under the Companies Act.<sup>71</sup> Companies' use of this structure can also evolve over time. For example, commentators originally criticized Hitachi as a company that utilized the company with committees structure for the traditional purpose of more closely coordinating the activities of its group companies.<sup>72</sup> However, it has more recently been praised for adding independent directors.<sup>73</sup>

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70 See 21st Century Managers Forum, *supra* note 68, Comments at Meeting of Corporate Governance Forum, Business Research Institute, Tokyo (Sept. 27, 2012). It should also be noted that, as a practical matter, search firms for high level placements such as directors and CEOs are not well developed or generally relied upon in Japan as compared to the United States. Accordingly, it might not be easy for a nomination committee to conduct a thorough, completely independent search. *Id.*

71 At present, four of the seven non-executive directors qualify as outside directors. See Corporate Governance, Toshiba, <http://www.toshiba.co.jp/csr/en/governance/governance.htm> (last visited 13 March 2013). Under the Companies Act a current or former executive director, executive, officer or employee of a company or any of its subsidiaries is excluded from the definition of outside director. See Companies Act, Art. 2, Item 15. Toshiba's approach is in keeping with the concept of combining insider expertise and authority with outsiders. The use of non-executive inside directors was, as noted above, included as a topic of the METI study group, *supra* note 48, and is considered a strong positive contribution to corporate governance by Toshiba. See Shimaoka, *supra* note 57.

72 See R. J. GILSON / C. J. MILHAUPT, Choice as Regulatory Reform: The Case of Japanese Corporate Governance, *Am. J. Comp. L.* 53 (2005) 343. This was possible due to the broad definition of "outside director" under the Companies Act. Recently proposed amendments to the Companies Act seek to narrow this definition by excluding directors from group affiliates. See Draft Amendments, *supra* note 47.

73 See Asian Corp. Governance Ass'n / CLSA Asia-Pacific Markets, 2012 Corporate Governance Watch Survey, quoted in Japan Downgraded in Corporate Governance Survey for Lack of Board Reform, Reuters, (19 September 2012), <http://www.reuters.com/article/2012/09/19/us-japan-governance-idUSBRE88I0AY20120919>. Adoption of the company with committees structure is also no guarantee of effective board monitoring. Ironically, Sony

Thus, such innovative experimentation may be limited so far to leading Japanese companies that have made real efforts in the field of corporate governance. For such measures to have a significant impact on Japanese corporate governance generally (and perceptions of it), these best practices must somehow be codified and spread more broadly. Big business generally opposes mandatory legal requirements,<sup>74</sup> but the effectiveness of other methods for improving corporate governance remains uncertain. A more robust “comply or explain” system involving the TSE may be one method worth exploring, but there are limits on how far stock exchanges can promote corporate governance issues that are not based on law.<sup>75</sup> Some kind of code of best practice might also be considered, and the Asian Corporate Governance Association and others have

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Corporation, which in the past was cited as the champion of “American-style” corporate governance, has recently been criticized for the board’s failure to supervise management during the company’s continued poor performance under CEO Howard Stringer from 2005–2011. With respect to corporate governance aspects, see, TSUDA, *supra* note 60. For Stringer as a failure, see W. PESEK, *Apple Offers Clues to Where Sony Needs to Head*, Bloomberg (7 February 2012), <http://www.bloomberg.com/news/2012-02-07/apple-offers-clues-to-where-sony-needs-to-go-commentary-by-william-pesek.html>. Others have defended both Stringer and Sony as doing reasonably well given the poor position and declining profits of domestic Japanese electronic companies generally. See, e.g., *Sony and its Boss: Stringer Theory*, Economist, 26 May 2011, <http://www.economist.com/node/18745381>. In addition to the issue of monitoring of management performance, there was also a significant dispute at Sony about hiring Stringer’s hand-picked successor as CEO. See Damion Rallis, *At Sony Corporation It’s the Same Old Sony*, GMI Ratings (Oct. 10, 2012), <http://www3.gmiratings.com/home/2012/10/at-sony-corporation-its-the-same-old-sony/>.

74 See, e.g., N. KEIDANREN, *Towards Better Corporate Governance* (14 April 2009) (Interim Discussion Paper on Key Issues), <http://www.keidanren.or.jp/english/policy/2009/038.pdf>. A government-sponsored proposal in 2002 to require at least one outside director was defeated, as business groups mobilized politicians to oppose the government’s plan. See GILSON / MILHAUPT, *supra* note 72.

75 Many Japanese seem to place their hope in the TSE acting as the champion of corporate governance reform, due both to the TSE’s positive attitude toward reform and to the cautious attitude of other actors including business groups, the FSA, and Japanese institutional investors. Y. MIWA, *Kōporeeto gabanansu seido hikaku to nichī-futsu kikan tōshi-ka* [A Comparison of Corporate Governance Systems and Institutional Investors in Japan and France]; M. MIZUNO, *SBF120 o kōsei suru furansu kigyō no gabanansu kaikaku – waga-kuni e no shisa* [Governance Reform of French Companies in the SBF 120 – Suggestions for Japan], Corporate Governance Research Group, Meiji Institute for Global Affairs, Tokyo, 12 October 2012 (comparing progress in corporate governance reform in Japan unfavorably to efforts in France, another stakeholder system, and expressing the hope that the TSE would take the lead in reform in Japan). In the United States, for example, the corporate governance section of the listing rules of the New York Stock Exchange were added in 2003 after the enactment of Sarbanes-Oxley.

advocated for such an approach in combination with a “comply or explain” requirement for listed companies.<sup>76</sup>

To date, the interesting reforms at leading Japanese companies, and an emerging “middle ground” of corporate governance practices, have gone largely unnoticed. Japan still has a reputation for poor corporate governance, at least among foreign institutional investors. Accordingly, further efforts must be made to determine acceptable minimum standards that are visible, accessible, and readily explainable so that progress can be more widespread and more readily demonstrated.

#### IV. CONCLUSION

It is very difficult to prevent or detect the kind of deliberate fraud that occurred in the Olympus case. Nevertheless, the Olympus scandal strongly highlights the greatest problem in Japanese corporate governance: the lack of an effective system for monitoring management.

Japan’s corporate governance reform efforts have been hampered by a perceived all-or-nothing choice: retention of the traditional company auditor system and downplaying or ignoring of monitoring issues or wholesale adoption of a form of the American-style monitoring model through selection of the optional company with committees structure. As a result, there has been little progress on the most widely debated issue of whether to require a minimum number of outside / independent directors.

A “mixed” system, in which a number of independent directors cooperate with company auditors and other insiders, offers some promise of a “middle ground” between the managing and monitoring models. In the absence of any overall agreement under the Companies Act or elsewhere on the contents or requirements for such a system, it has been left to individual companies to deal with corporate governance aspects of globalization of their activities and increased scrutiny from foreign institutional investors. In fact, a number of individual Japanese companies are already experimenting with more ambitious kinds of mixed or hybrid models that go beyond adding a small group of independent directors.

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76 See, e.g., Presentation by Asian Corporate Governance Association, Corporate Governance in Japan: Issues for Long-Term Investors 41 (9–11 March 2009) (recommending that Japan develop an official code of best practice, as has been done in many other countries, to combine traditional strengths with new standards), [http://www.acga-asia.org/public/files/ACGA\\_Investor\\_Delegation\\_Japan\\_March2009\\_Issues\\_Document\\_Final.pdf](http://www.acga-asia.org/public/files/ACGA_Investor_Delegation_Japan_March2009_Issues_Document_Final.pdf). Japan has a corporate governance code that sets forth general principles, but it has not been very effective in promoting good corporate governance practices compared to other countries such as Germany. See JAPAN CORPORATE GOVERNANCE COMMITTEE, Japan Corporate Governance Forum, Revised Corporate Governance Principles (26 October 2001), [http://www.ecgi.org/codes/documents/revised\\_corporate\\_governance\\_principles.pdf](http://www.ecgi.org/codes/documents/revised_corporate_governance_principles.pdf).

It is too soon to judge whether the current post-Olympus ferment in Japan will lead to a more effective management monitoring function within the traditional Japanese corporate structure. Such a result is achievable within the basic framework of the Japanese system of corporate governance without wholesale adaptation of an American monitoring model. Although amendment of the Companies Act has been a very cautious process, there is now a recommendation for Japan's first use of a "comply or explain" approach and the likelihood that the TSE will require one outside / independent director for listed companies in the near future. This approach could eventually lead to a code of best practice that is based on a mixed system with company auditors and a number of independent directors and is implemented through a "comply or explain" approach for listed companies. Such a development would represent a welcome improvement in Japanese corporate governance for Japanese stakeholders and foreign shareholders alike.

However, it is unclear how long the post-Olympus window of opportunity to reform corporate governance will remain open and whether business groups will act in time. Some major business groups still remain opposed to reform, but others fear that if the current opportunity to improve corporate governance in a flexible manner is not seized, the next major corporate governance scandal conceivably could result in rigid and costly mandatory requirements similar to the Sarbanes-Oxley Act. We will soon see whether reformers can utilize the post-Olympus opportunity to make progress in the monitoring of management through hybrid models and practical measures to make such monitoring effective.

#### SUMMARY

*Since the 1990s global institutional investors have strongly advocated the widespread use of independent directors in accordance with the U.S.-derived board monitoring model. Japan may be the country that has displayed the greatest resistance to this prescription for reform.*

*The fallout from the scandal over financial reporting at Olympus Corporation provides a new opportunity to reconsider both theoretical and practical issues related to Japanese corporate governance reform. This Article proposes that the deadlocked debate in Japan over director independence be expanded to produce more effective reform.*

*The aim is to pay closer attention to current proposals and to the ongoing experimentation at a number of leading Japanese companies. Their goal is to develop a mixed governance system that seeks a "middle ground" between Japan's traditional management board model and the monitoring model. Proposals should also consider means to spread such best practices more broadly among Japanese companies.*

*Although current proposals and experimentation in Japan have the potential to achieve significant corporate governance reform, it is too early to judge whether the post-*

*Olympus ferment will, in fact, lead to the incorporation of an effective management monitoring function into the traditional Japanese corporate structure.*

#### ZUSAMMENFASSUNG

*Global agierende institutionelle Investoren werben seit den 1990er Jahren mit Nachdruck für einen verstärkten Einsatz von unabhängigen Mitgliedern in den Verwaltungs- bzw. Aufsichtsgremien von Unternehmen nach US-amerikanischem Vorbild. Japan ist vermutlich das Land, das sich diesem Ansinnen am nachhaltigsten widersetzt hat.*

*Die Nachwirkungen des Rechnungslegungsskandals bei dem Unternehmen Olympus geben Anlass, erneut über theoretische und praktische Aspekte im Zusammenhang mit der Reform der Corporate Governance in Japan nachzudenken. Der Beitrag schlägt vor, die festgefahrene Diskussion über die Unabhängigkeit von Verwaltungsratsmitgliedern in Japan perspektivisch zu erweitern, um so eine effizientere Reform zu ermöglichen. Ziel ist, den aktuellen Vorschläge und organisatorischen Experimenten führender japanischer Unternehmen größere Aufmerksamkeit zu schenken. Diese versuchen einen Mittelweg zwischen Japans tradiertem Modell eines von Managern dominierten Verwaltungsrates und eines demgegenüber stärker von Aufsichtsaspekten geprägten zu finden. Entsprechende Vorschläge müssen zugleich der Problematik der Umsetzung bei den japanischen Unternehmen Rechnung tragen.*

*Auch wenn die diskutierten Vorschläge und Experimente das Potential haben, zu einer bedeutenden Reform der Corporate Governance in Japan zu führen, ist es noch zu früh, um beurteilen zu können, ob es im Zuge der Unruhe nach dem Olympus-Skandal tatsächlich zur Integration einer effizienten Unternehmensüberwachung in die tradierte japanische Unternehmenskultur kommen wird.*

*(Übersetzung durch die Redaktion)*