# Americanization of Stock Corporation Laws Around the World, and Shareholders' Derivative Suits as a Forgotten Element Therein: A Caveat to Discussions on the Convergence of Corporate Laws

*Kenichi Osugi**



## I. THE THEME

This paper argues how each country should advance a company law reform in connection with the ongoing "Americanization of company law" around the world, especially from the viewpoint of a lawyer in a country that has been heavily influenced by continental European laws. Put concretely, the author will discuss what U.S. corporate law[1] looks like from the perspective of a Japanese lawyer, and what other nations should have in mind in reforming their corporate laws by utilizing the merits of U.S. corporate laws. While U.S. corporate lawyers and corporate law itself have recently become more and more influential in other countries' reform of their corporate laws,[2]

---

* This thesis is a reprint of that which originally appeared in: An Anthology Commemorating Retiring Prof. Dr. Woo Hon Gu – Perspectives of Korean Commercial Law in the 21st Century (Seoul June 2002). The author deeply acknowledges the permission to reprint it in this review. The cited URLs and information in this paper are as of the end of January, 2002.

1 Though each of the fifty-one jurisdictions has its own business corporation code in the U.S., they are much more similar to each other than they are to company codes abroad, and therefore it is not inappropriate to use the term "American corporate law(s)" or similar expressions.

2 See, *e.g.,* J.C. COFFEE, Inventing a Corporate Monitor for Transitional Economies: The Uncertain Lessons from the Czech and Polish Experiences, in: K.J. HOPT / H. KANDA / M.J. ROE / E. WYMEERSCH / S. PRIGGE (eds.), Comparative Corporate Governance (Oxford 1998) 67; J.C. COFFEE, Privatization and Corporate Governance - The Lessons from Securities

this article's contribution is to show some aspects from outside the U.S. The discussion below presupposes publicly held stock corporations; reform of laws on closely held corporations requires a separate analysis.

Before moving on to the details, let me briefly explain the viewpoints that are unique to the author. Approximately one hundred years ago, Japan threw away its native, traditional laws and imported Western laws, which form the fundamental part of our modern law. Specifically, we inherited public law from Germany, general private law (related to trades) from France, and commercial law from Germany. During the GHQ's (General Headquarters') occupation of Japan after World War II, American influence gained in importance and has been prominent in all fields of law since then. However, "law" comprises not only written laws, but also the people's perception of law. In the Japanese case, the inheritance of Western laws in the late nineteenth century was carried out with an unsophisticated neglect of indigenous law, resulting in a general attitude – not only among ordinary people, but also among the elite who had the clout to make and interpret statutes – that considered law to be "foreign" in origin and therefore remote from everyday life. This attitude has lasted until now, though the hostility and indifference to "Western" law is gradually decreasing. Moreover, even a written law in Japan is often an amalgam of several Western laws, making Japanese law different from German, French, or American law. Ironically, Japanese law mimicked only the surface of those laws.

Therefore, the author's viewpoint has been forged in a country with a different cultural background from those in the Western world, but with an inheritance of Western law and a system of law that is a combined product of several Western – mainly Continental – legal systems. In addition, the economic point of view comes also from a nation that enjoys the world's second largest economy but has suffered economic downturns for more than a decade. It is not clear what significance this paper will have for countries such as Korea, whose law was influenced by Japanese law, or eastern European countries that once had a socialist economy and are now developing market economies.[3] But I do hope this paper will provide some aspects to help neutralize the views of American law and lawyers and of a national economy that has been successfully attracting a great deal of attention from all over the world.

---

Market Failure: Journal of Corporation Law 25 (1999) 1; B. BLACK / B. METZGER / T. J. O'BRIEN / Y.M. SHIN & INTERNATIONAL DEVELOPMENT LAW INSTITUTE, Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness: Journal of Corporation Law 26 (2001) 537; and C.J. MILHAUPT, Privatization and Corporate Governance in a Unified Korea: Journal of Corporation Law 26 (2001) 199.

3 See K. OSUGI, How Should We Enforce Minority Shareholders' Rights in Russia? Overhauling the Self-Enforcing Model of Corporate Law in Transition Economies: Unpublished working paper (2000), available at <*http://www.oecd.org/pdf/M000015000/M00015332.pdf*>; for information on Company and Securities Law Reforms in Russia.

## II. DYNAMICS IN U.S. CORPORATE LAW

*Hansmann* & *Kraakman* [4] argue that the competition of corporate law among the 51 jurisdictions in the U.S. is essentially over, and that now is the time to see the international competition of corporate law worldwide; that international competition is leading to the convergence of the corporate laws involved toward U.S. corporate law, which has at its core the formula of maximization of shareholders' wealth; and that corporate law models other than shareholder supremacy – such as the employee-oriented model and the state-oriented model – will soon be defeated because of their lack of efficiency and competitiveness.

*Black*,[5] too, insists – especially regarding the privatization of former socialist economies (transition economies) – that American securities markets and regulations will be the (only) effective model for strengthening a nation's economy. These include effective regulators, an honest judicial system, civil discovery and class actions, financial disclosures with independent audit, reliable accounting rules, and an independent and competent rule-making agency.

This paper does not attempt to comment on those arguments.[6] Without a doubt, the facts show a global trend toward the Americanization of corporate laws and securities regulations among East and Southeast Asian countries, Latin American countries, as well as western European countries. The issue here is not whether the U.S. corporate and securities laws are worth imitating, but which parts of them are useful, and how other countries can learn from them. Critical insight into the merits and demerits of U.S. laws is necessary but may well be overlooked by U.S. scholars.

Needless to say, what is "the best corporate law" is a question that is dependent on the economic setting of each nation.[7] Imitating the shape of the U.S. system (institu-

---

4 H. HANSMANN / R. KRAAKMAN, The End of History for Corporate Law: Georgetown Law Journal 89 (2001) 439.

5 B. BLACK, The Legal and Institutional Preconditions for Strong Securities Markets: UCLA Law Review 48 (2001) 781.

6 A brief comment, however, is probably needed in regard to the discussion in HANSMANN / KRAAKMAN (*supra* note 4). "Shareholders' interests" can be defined as being either short-term or long-term. Long-term shareholders' interests could be consistent with interests of other constituencies such as company employees from *ex ante* perspectives: both shareholders and employees would be better off with a contract in which shareholders promise to pay harder workers higher salaries, and such a contract would accelerate the economic growth of a nation. On the other hand, short-term shareholders' interests would result in opportunism that deprives due expectations of other constituencies and therefore economic inefficiencies. The critical issue here is to what extent contracts among constituencies and other institutions in a state could coordinate various interests in particular surroundings, and how a state can improve its institutions in this regard. If many people begin feeling that the shareholders' supremacy fails to harmonize those multi-dimensional interests, the norm will lose its supporters.

7 The argument on convergence of corporate laws paradoxically poses a challenge to the traditional methodology often seen in developing countries, such as comparison of laws and

tions) does not necessarily make sense to others. Even if simple duplication works in one national economy at a given time, it will probably need some corrections as time passes.[8] Here I propose a hypothesis: The predominance of U.S. corporate and securities laws over that of other countries lies not in their contents but in the self-correcting mechanism embedded in the institutions.[9] The embedded self-correction program comprises three elements: the interstate competition of corporate law; a powerful regulator for securities transactions (the Securities and Exchange Commission, the SEC); and private actions such as shareholders' derivative actions (also known as shareholders' representative suits) and investors' class actions. The interstate competition successfully eliminates over-regulation,[10] while the securities regulator and private actions cope

importing "developed" foreign statutes. Legal dogmas should be understood rather as a flexible framework, and some of them – *e.g.,* the principles of fulfillment and maintenance of share capital (*shihon jûjitsu*, *iji no gensoku*) in Japan's company law – should be reexamined, and probably modified or abolished.

8 A function that institutions play is more essential than a superficial form or appearance of the institutions, such as lifetime employment or cross-shareholding in Japan; and often "written" laws belong to the latter. A specific form of institutions, however, plays some role in hindering institutions' *status quo* from evolving to adjust to new surroundings. Also, a change of an institutional form may result in the mutation of the system, *i.e.*, a function of particular institutions. Thus, the form is of significance to that extent. See R.J. GILSON, Globalizing Corporate Governance: Convergence of Form or Function?: unpublished working paper (2000), available at <*http://papers.ssrn.com/sol3/papers.cfm?abstract_id =229517*>; herein GILSON argues the convergence of corporate governance from the perspectives of interaction of forms and functions.

9 R.J. GILSON, Corporate Governance and Economic Efficiency: When Do Institutions Matter?: Washington University Law Quarterly 74 (1996) 327. GILSON contends that Japanese and German corporate governance is good at stability, which protects various constituencies' long-term commitments that cannot be protected appropriately by contracts or statutes, while the governance of the U.S. excels in adaptability, or "mutability," to changing environments. Though they deal with corporate governance, U.S. corporate laws and securities regulation are also assumed to be better at adapting to a change of surroundings than other laws.

10 It is well known that the interstate competition of corporate law in the U.S. started at the end of the nineteenth century as a competition for incorporation fees, and that it has continued to be a driving force in reforms of corporate statutes for over 100 years. R. ROMANO, The Genius of American Corporate Law (1993), is a comprehensive monograph on this topic, and it is persuasive in regarding this competition to be a "self-correcting pressure" (at 148). Recent scholarly discussions on this issue in the states could be roughly summarized as follows:
1) The competition among states has helped the improvement of state corporate statutes;
2) Each state law has become almost the same as others with this competitive pressure, but it does not necessarily mean the current laws are the "best" corporation laws, or, in other words, there could be a better corporate law;
3) The Delaware law, the champion of interstate competition, is not very different from those of other states as a written law, but Delaware continues to be the champion because it has a special Chancery court (a division of state courts which deals with equity as opposed to common law) for corporate matters which helps its judges to obtain experiences and expertise in corporate litigation. Also, "equity" court may dispense with jury trials that could invite legal unpredictability.

with dangers that state competition could invite. We should avoid both over-regulation and under-regulation, but each government agency or private citizen lacks the incentives to regulate at the optimum level. Although either a governmental or private regulation alone would lead to under-regulation, the combination of public and private regulations comes closer to the optimum level. It is also noteworthy that U.S. law has long developed, and is still developing, legal rules and doctrines aimed at curtailing over-regulation from frivolous private lawsuits.

Can other nations acquire those three elements of this self-correction program? Interstate competition in the U.S. is probably being replaced with international competition.[11] Introducing strong regulators into securities markets, however, is politically difficult in many nations.[12] And learning the real practices of the SEC in securities regulations is even harder for some other nations than it looks:[13] it is easy to import written rules but difficult to learn their enforcement. Japan, for instance, has almost the same rules in securities regulations and a similar supervisory agency,[14] but it is suspected that the agency has sometimes exercised its powers not to foster investors' benefit but to adhere merely to the forms. It is safe to assume that a powerful regulator is needed for a strong securities market, but having it function well is not as simple as ABC.

---

11 However, a close economic relation between different jurisdictions alone does not necessarily cause competition of company laws. Canada has rarely experienced competition of company laws among provinces in spite of its federal system. Neither have Western European countries competed against each other in company legislation. See ROMANO (*supra* note 9) at 118 *et seq.* Therefore, careful attentions should be paid to whether ongoing international competition of corporate laws is of the same nature as that in the U.S. in this respect.

12 An official regulator and private actions do complement each other. And if we can have either one but cannot have both, official regulators are usually a more direct and effective solution than private lawsuits in dealing with possible harm caused by flexible company rules. See E. GLAESER / S. JOHNSON / A. SHLEIFER, Coase versus the Coasians: Quarterly Journal of Economics 116 (2001) 853. However, in transition economies, or until infrastructures in a national economy have been furnished, an effective securities regulator is often politically hard to establish. For that reason, this paper deals with private actions, and shareholders' derivative suits are the main focus, because class actions in relation to securities regulations have larger problems to cope with before their introduction to an economy.

13 R. LA PORTA / F. LOPEZ-DE-SILANES / A. SHLEIFER / R.W. VISHNY, Legal Determinants of External Finance: Journal of Finance 52 (1997) 1131; Law and Finance: Journal of Political Economy 106 (1998) 1113; The Quality of the Government: Journal of Law, Economics and Organization 15 (1999) 222; Investor Protection and Corporate Governance: Journal of Financial Economics 58 (2000) 3. Herein the authors, who have attempted to compare economic performance of national legal institutions, are intriguing in including unwritten rules and judicial systems in their definition of "institutions." However, it seems that those studies need additional sophistication of both methodology and focus before their implications can be applied to a specific situation.

14 The Securities and Exchange Surveillance Commission (SESC, *Shôken Torihiki-tô Kanshi I'inkai*) was established in 1992. See H. AOKI, The New Regulatory and Supervisory Architecture of Japan's Financial Markets: ZJapanR 12 (2001) 101. For further official information about it, visit <*http://www.fsa.go.jp/sesc/english/index.htm*>.

This paper puts an emphasis on private actions, especially shareholders' derivative actions. No nation other than the U.S. - including England, whose law was the ancestor of U.S. law – places particular emphasis on private actions in corporate and securities laws. This article insists that

1) there is complementarity among the three institutions (hereinafter called "triangle"), *i.e.,* deregulation through interstate or international competition of corporate law, shareholders' derivative lawsuits, and outside (independent) directors on the boards at publicly held companies;
2) each country can and should import this triangle as a package; and
3) in so doing, caution must be taken to have fine-tuning in order to restrain the institutions from going wrong. Securities regulations are outside the scope of this paper.

This triangle approach is on the one hand more comprehensive than the traditional methodology of analyzing particularities of U.S. corporate law separately from each other, and it shares with *Black*[15] interests in handling legal institutions and market institutions together. On the other hand, compared to *Black*, this paper is more conservative in paying attention to corporate law rather than securities regulations, and modest in proposing a much smaller package. I do not disagree with *Black* on his all-embracing list of recommendations, but I am attempting to take a more realistic approach: a step-by-step reform needs to break down inclusive suggestions into manageable units. Full disclosure, which *Black* advocates, is undoubtedly essential in my approach as well, and I presuppose it in the discussion below. Because of their difficulty and time-consuming nature, *Black*'s other suggestions – such as setting up effective regulatory agencies, training and increasing legal and accounting professionals, and establishing an enforcement system like class actions – are purposely excluded from the discussion below.[16] However, further research is needed to look into the extent to which complementarity exists within the modest package presented by this paper and other suggestions of his.

---

15 BLACK (*supra* note 5).

16 BLACK (*supra* note 5) insists that efficient securities markets and various kinds of infrastructures that support them do cope the best with managers' misappropriation of companies' assets (self-dealing) that has been observed in some transition economies. However, though those efficient markets and other infrastructures, once created, will be extremely beneficial, they cannot be built in a day, and codification alone cannot save the situation. It is essential for countries without sufficient economic infrastructures to ensure means to police self-dealing, and I focus on shareholders' derivative actions for that reason.

## III. A TRIANGLE HYPOTHESIS: COMPLEMENTARITY AMONG THE THREE INSTITUTIONS

### 1. *Three Particularities in U.S. Corporate Law*

From a comparative viewpoint, shareholders' derivative suits, outside directors in public corporations, and less prohibitive rules are undoubtedly three important – if not the only important – features in U.S. corporate law.

#### a) *Shareholders' Suits*

In terms of legal doctrines, U.S. law allows a wider range of shareholders to enforce a company's claims against a broader scope of defendants for a wider cause of action than any other laws. And practical views also point out that U.S. institutions give large – even excessive – incentives to sue to plaintiff shareholders, or, to be exact, to attorneys for potential plaintiffs.

#### b) *Outside Directors*

Though corporation statutes in the United States do not necessarily obligate large corporations to appoint directors who are not managers or other sorts of company insiders, most listed companies as well as some companies that are not listed appoint outsider directors. The custom for persons who do not belong to the top-to-bottom chain of command to become board members is also common at public companies in the United Kingdom. German supervisors are said to be akin to outside directors in the U.S. and U.K. because they play a similar monitoring role.[17] In Japan, more and more companies are appointing outside directors, but the average rate of outsiders on a board is still extremely low, and large numbers of publicly held corporations are still reluctant to have outsiders on their board. Since state corporation laws in the U.S. don't mandate outside directors, we need to make clear what makes the difference between the U.S. and Japan before arguing for adoption of a mandatory outsider board.

---

17 In large German companies, the management board (*Vorstand*) engages in management decisions and their implementation, whereas the supervisory board (*Aufsichtsrat*) engages in monitoring directors (two-tier system). See GOVERNMENT COMMISSION ON THE GERMAN CORPORATE GOVERNANCE CODE, The Draft of a German Corporate Governance Code (2001), available at <*http://www.corporate-governance-code.de/eng/kodex/index.html*>.
The shareholders meeting appoints one half of the supervisors while employees appoint the other half, and the supervisory board in turn appoints members of the management board (directors). To be sure, a management board and a supervisory board are two separate councils; a supervisor cannot concurrently be a director, and a director cannot be a supervisor at the same time. However, CEOs attend supervisory boards in practice.
A U.S. board consists of approximately ten directors, including two or three executive officers (inside directors), and therefore boards with majority outside directors have the power of appointing and dismissing major executive officers. A rough comparison of American boards and German boards will be made in Part IV 2. b), *infra*.

*c) Deregulated Stock Corporation Law*

U.S. corporate laws are generally more flexible and less prohibitive than other stock corporation codes. To see this, take the Japanese rule that requires an approval of the shareholders' general meeting for the company's sale of all or all its important business(es). Dogmatically, the interpretation of the notion "all or a substantial part of business(es) of the company" becomes the central question,[18] while in practice, a rule of thumb is whether the transferred business consists of roughly ten percent of the entire business in terms of the turnovers, earning before tax, assets, numbers of employees, and so forth.[19] Quite differently, the Delaware Business Corporation Act obligates an approval of the shareholders' meeting only when the transferred business consists of "all or substantially all."[20, 21] It is obvious which rule is more stringent.

The corporation codes of the U.S. and Japan[22] are also different in rules regarding the issuance of securities and finance. General Motors (GM) was the pioneer in inventing and issuing exotic securities called "Tracking Stock,"[23] and that was in 1984. The Ministry of Justice in Japan changed its negative attitudes toward those novel securities and accepted Sony's application for the amendment of company registration, which is the condition of issuance of multiple classes of shares, as late as 2000.[24] Another example is a regime of class voting. Class voting is less relevant to the subject of this paper since it is mainly used in venture businesses and other closely held companies, but it offers a good perspective for discerning fundamental differences between U.S.

---

18 Art. 245 *Shôhô* (Japan's Commercial Code, Law No. 48/1899, as amended by Law No. 79/2001). In interpreting it, Fuji Forestry Mfg (*Fuji Rinsan Kôgyô*) v. *Kiso Kanzai Shibai Kyôdô Kumiai*, 19-6 *Minshû* 1600 (Supr. Ct, P.B. Sept. 22, 1965) held that a business transfer that needs shareholders' approval is "a transfer of all or a substantial part of a company's assets, including intangible factors of economic value such as customer relations, which are organized for a particular business purpose and which function as a whole, provided that the transfer thereby causes the transferee to succeed all or a substantial part of the business activities which were run by the transferor with those assets, and causes the transferee to owe a duty to not compete to the extent it succeeds as Art. 25 *Shôhô* is applied."

19 I. KAWAMOTO ET AL., *'Eigyô no jûyô naru ichi-bu' no handan kijun* [On Criteria for Importance of the Transferred Business]: *Bessatsu Shôji Hômu* 43 (1979) 68.

20 Sec. 271.

21 Though I once heard that 70 percent of the market capitalization is the rule of thumb in practice, it may not be reliable information.

22 See, *e.g.,* H. AOKI, Revisions of Corporate Law: ZJapanR 12 (2001) 101 and H. AOKI (*supra* note 14).

23 Tracking stock, or what is sometimes called letter stock or alphabet stock, refers to a class of shares structured to obtain market prices that are linked not to the assets and profitability of the issuing company as a whole but to those of a part of the issuing company (or its subsidiary). For the details of Sony's tracking stock, see R. SEKIYA, *Kogaisha rendô kabushiki (nihon ban 'tracking stock') no kaihatsu* [The Invention of Tracking Stock in Japan]: *Shôji Hômu* 1581 (2000) 4.

24 Later Sony issued the tracking stock on June 20, 2001, and it became listed on the Tokyo Stock Exchange on the same day.

and Japanese corporate codes. This scheme enables Class A shareholders to appoint a certain number of (*e.g.,* three) directors on their behalf, while Class B shareholders appoint some others (*e.g.,* two) for their own. This has been prohibited in Japan for a long time, and at last its deregulation for closely held companies has come in the planned Commercial Code revision in May 2002. Scholars of comparative law will consider Japanese stock company law to be abnormal in rejecting articles of incorporation that are the product of negotiations among shareholders even for closely held companies.[25]

Structural changes of stock corporations are another typical area that is loosely regulated in the U.S. and heavily regulated in Japan. For instance, U.S. companies make use of distribution of their subsidiary's stock to their shareholders as in-kind dividends so the parent can let its shareholders be the new owners of the subsidiary entity and therefore disconnect its own ownership relation with the subsidiary. On the Japanese side, recent revision of corporate law, effective April 1, 2001, provided for a set of complicated rules, especially for a company split while maintaining the rule against in-kind dividends.[26] A more serious problem in Japan lies in cross-border mergers and other structural changes of companies, on which the Japanese Ministry of Justice has not

25 While shareholders in German stock companies (*Aktiengesellschaft, AG*) enjoy only a limited freedom of providing for internal relationship, members in limited liability companies (*Gesellschaft mit beschränkter Haftung, GmbH*) in Germany are allowed to contract for a wider range of issues within the company. In Japan, the Limited Liability Company Act (*Yûgen kaisha-hô*) permits only narrow room for private autonomies, and its scholarly interpretation tends to make it even narrower.

26 Various kinds of company splits are classified as follows: one in which a split-out entity forms a new entity (split accompanying formation, *shinsetsu bunkatsu*) and one in which a split-out business merges into another entity (split accompanying merger, *kyûshû bunkatsu*); simultaneously, one which creates the original corporate entity's holding the new shares issued by a split-out business (split resulting in separation of assets, *butteki bunkatsu*) and one which breaks up the ownership relation between divided businesses and in which the same shareholders of the original entity become the shareholders of split-out businesses, as in spin-offs in the U.S. (split resulting in separation of ownership, *jinteki bunkatsu*). The text accompanying this note is classified as *shinsetsu bunkatsu* and *jinteki bunkatsu*.

Though it is not rare in Germany for a company to distribute a subsidiary's shares to its shareholders with a reduction of share capital, this type of spin-off has had only one known example in Japan in 1957. See ANONYMOUS, *Koito seisakujo no bunkatsu* [The Spin-off of K.K. Koito Mfg.]: *Shôji Hômu* (1957) 19. It is partly because the Japanese Commercial Code requires companies planning reduction of share capital to give notice to all known creditors, Art. 376 para. 2 *Shôhô*. Since the new law permits companies' *jinteki bunkatsu* only with the same strict rule for creditors' protection, *jinteki bunkatsu* has been used rarely since the new law came into effect.

Instead, *butteki bunkatsu* and/or *kyûshû bunkatsu* have been widely used to date. The latter is a convenient way to re-structure businesses among several entities toward choice and concentration on core competence (de-conglomeration), which is quite necessary in the exhausted Japanese economy. In fact, reopening a route for companies to divide their businesses and set up subsidiaries (which was once made difficult by the Commercial Code Revision of 1990, which heavily regulated in-kind contribution) was one of the most important reasons for the reform in 2000. See *supra* note 42 and accompanying text *infra*.

changed its toughest ban and continues to reject applications for the amendment of company registrations for cross-border M & As; applications must be accepted for those transactions to be effective legally. In the U.S., interstate mergers have a long history, as do international mergers. Even dogmatic German lawyers have changed their attitudes and loosened the absolute ban on international mergers and acquisitions.[27] In addition, in October 2001 the Council of the European Union (EU) adopted a regulation providing for *Societas Europaea* (SE) to enter into force on October 8, 2004, and the regulation is thought to be substantially facilitating cross-border M & As.[28] The result will be that Japanese companies have fewer choices in buying out foreign companies,[29] and companies outside Japan will have difficulties in purchasing potentially viable but financially distressed businesses in Japan. Unquestionably, the former means a loss of competitiveness of Japanese corporations, and the latter restricts opportunities to revitalize the Japanese economy.

### 2. *Complementarity between Shareholders' Derivative Actions and Outside Directors*

Obviously the institutions of shareholders' derivative suits and outside directors are mutually complementary. Outside directors are essential in constraining abuses and misuses of shareholders' suits; in that sense, outside directors are active supporters of incumbent managers. On the other side, derivative suits embody the concept of "outsiders on board" and restrain those outsiders from being pseudo-gatekeepers and neglecting their monitoring duty; on this side, outside directors function in a way that is not welcomed by managers and officers. Outside directors are carrots and sticks for insiders, and each side deeply relates to the institution of shareholders' suits.

---

27 B. GROSSFELD, *Internationales Gesellschaftsrecht, in: J. von Staudingers Kommentar zum Bürgerlichen Gesetzbuch mit Einführungsgesetz und Nebengesetzen, Einführungsgesetz zum Bürgerlichen Gesetzbuch / IPR, Internationales Gesellschaftsrecht, Neubearbeitung* (1998) *Rn.* 488.

28 COUNCIL REGULATION (EC) No. 2157/2001 of 8 October 2001 on the statute for a European Company (SE). Also see COUNCIL DIRECTIVE 2001/86/EC of 8 October 2001 supplementing the Statute for a European Company regarding the involvement of an employee.

29 Because of the reasons mentioned in the text, mergers or share exchange – in which an acquiring company buys all the outstanding shares of an acquired company from the latter's shareholder in exchange for the acquirer's new stock, according to the share exchange plan that was approved by the shareholders' meetings of both the acquiring and acquired companies (*kabushiki kôkan*) and which was introduced by the reform in 1999 – between companies of different nationalities are impossible. To be sure, a company can use cash to acquire foreign entities as long as it obeys the securities regulations of the place where it plans to tender shares; stock-for-stock tender offers that provide newly issued shares with the old shareholders of acquirees are quite difficult because of the inspector's evaluation rule referred to in note 42 and accompanying text *infra*.

### a) *Outside Directors as a Safeguard Against Misuse of Shareholders' Suits*

Most company laws around the world prepare a system in which claims of a company against its directors are enforced by shareholders.[30] It is, however, idiosyncratic of U.S., Japanese, and some other corporate laws to put little restriction (standing) on shareholders as a plaintiff.[31] For example, Art. 267 of Japan's Commercial Code (*Shôhô*) allows a shareholder who holds more than one unit of shares to initiate a derivative action against company directors. That can cause both effective deterrence on managerial misfeasance and shareholders' abuses and misuses. Misuse of derivative actions includes cases that are negligent as well as malicious: more often than not, a negligent shareholder, believing it is in the best interest of the company and all the shareholders, brings a suit which is nonetheless frivolous in the sense that the action goes against the shareholders' best interest. This risk of trivial derivative suits doing harm to shareholders as a whole is evident when a company in whose name or right a derivative action is brought is large and public. In the U.S., public companies faced with frivolous lawsuits often set up Special Litigation Committees (SLCs), comprised mainly of disinterested outside directors, and SLCs are supposed to decide whether the benefits of the suit outweigh its cost by gathering the professional opinions of lawyers, accountants, and consultants, and other relevant information. Its essence is that the decision to continue or terminate the suit is made by a group of people who are independent from both incumbent managers and plaintiff shareholders, and are learned enough to carry out the cost-benefit analysis with sufficient input of opinions and information and with group discussions. Also important is the court's role in screening out recommendations that are not reliable because they were products of managerial influence and biases.

Parallel devices in Japan are worth attention to see the difficulties in importing the scheme of derivative suits from U.S. law. The court may order plaintiff shareholders to provide boards to secure the possible claim that the defendant directors have against the plaintiff shareholders because bringing the derivative suit constitutes tort against the directors in some situations. Judges in Japan, however, have exercised discretion in ordering security so as to discourage shareholders' suits that go against all the share-

30 German law, for example, provides that a shareholder cannot herself sue directors on behalf of the company, but shareholders aggregately holding 10% or more of the outstanding stock of the company may apply to the court in quest of an appointment of a special representative who is supposed to become a plaintiff suing the directors and/or supervisors. The reform in 1996 also enables shareholders holding at least 5% or par value of 500,000 Euro to apply to the court in case of serious misfeasance. § 147 AktG (*Aktiengesetz,* German Stock Corporation Act).

31 Strictly speaking, U.S. laws have other restrictions on shareholders as a derivative plaintiff, such as a requirement of certain months of share ownership before bringing a suit, a requirement that the plaintiff shall have already been a shareholder when the cause of action became known to her or the general public, and so forth. Those technical restrictions, however, work very little.

holders' best interest, rather than to secure the potential claims.[32] This practice could be seen as either a deviation from the legislative intent or a healthy evolution of case law.[33]

Despite the fact that some sort of deterrence against misused derivative suits is needed, it should be articulated that the discretional use of the bond order in Japan is an inferior device to American SLCs. In the U.S., a bond is rarely required to be posted in the states whose statutes provide for security for expenses, and other states (approximately two-thirds of all states) have abolished the security order.[34] That is partly because courts[35] are not good at making a cost-benefit analysis for continuing the proceedings. Nobody can make a better decision as to the termination of a derivative case than experienced business people who are independent from both sides. Thus, outside directors who are widespread in U.S. public companies do help to get the frequency of derivative suits closer to the optimum level.

Another example is the supplementary intervention (*hojo sanka*) of the company in whose name or right a derivative action is brought on behalf of the defendant directors. A supplementary intervenor (Art. 42 *Minji soshô-hô*, Japan's Code of Civil Procedure), who is different from an independent intervenor (Art. 47 *Minji soshô-hô*), may support only one of the two main parties. In the U.S., though, the company is usually sued as a co-defendant by plaintiff shareholders, and the company's standing to be sued is understood merely as a formality that is necessary only to bar other shareholders from suing the same directors on the same cause of action in the future. Correspondingly, the company's allegations and defenses in the procedures are fairly restricted.[36] Quite the opposite is true in Japan: though a company participates in a case as a "supplementary" intervenor, it does everything instead of the defendant directors.[37] It devotes its time to the

32 *Morita et al.* v. *Anonymous*, *Hanrei Jihô* 1504, 121 (Tokyo District Court [*chihô saibansho*], July 22, 1994) is an apparent example.

33 K. ÔSUGI, *Kabunushi daihyô soshô no ranyô he no taisho* [How to Deal with Abusive Derivative Actions?]: *Hanrei Taimuzu* 1066 (2001) 50 (in Japanese), criticizes this attitude of courts.

34 See AMERICAN LAW INSTITUTE, Principles of Corporate Governance: Analysis and Recommendations (1994) at § 7.04 Comment h.

35 Rule 23.1 of the Federal Rules of Civil Procedure (1966) in the United States provides that: "The derivative action may not be maintained if it appears that the plaintiff does not *fairly and adequately represent* the interests of [all] shareholders [...]" (emphasis and bracketed words added by the author). The "adequate representation" means a wide range of discretion given to the judges, which is the feature of common law (as opposed to civil law) tradition. This "adequate representation" concept is borrowed from the rules on class actions. See Rule 23 of the Federal Rules of Civil Procedure.

36 See AMERICAN LAW INSTITUTE (*supra* note 34) at §7.05.

37 *K.K. Manpei* v. *Yamamura,* 55 *Minshû* 30 (*Saikô Saibansho* [Supreme Court of Japan], P.B. Jan. 30, 2001) held that "A stock corporation may intervene in the derivative case on behalf of the defendant directors if the cause of the derivative action is that the board of directors made a decision illegally."

procedure, retains lawyers, and compensates those who essentially defend sued directors. And the decision of the company to intervene in the case is usually made by the board of directors, which is often predominated by inside interested directors![38] This ridiculous result stems from the juxtaposed nature of Japanese law: German doctrine on supplementary intervention (*Nebenintervention* in German) was grafted onto the American equitable remedy of derivative actions without any serious analysis of the interests of the parties involved, especially those of the silent shareholders collectively as the potential party.[39]A company's intervention eliminates excessive burdens on the defendant directors on the one hand, and suppresses the legitimate use of derivative actions. The best interest of *all* the shareholders must be the criterion that is applied to the arbitration between those accounts, but nobody represents shareholders as a whole in Japan's setting. Compared to this, enormous burdens on defendant directors are removed in the U.S. in a more sophisticated manner, in which independent directors decide whether to reimburse the cost incurred by defendant directors.[40]

### *b) Derivative Suits as a Device to Make Outside Directors Independent*

It is relatively easy for managing directors to bypass seemingly harsh statutory rules. In detailing statutory requirements for outside directors on boards of publicly held companies, it is of little help to refine the legal rules on their qualifications, appointment, tasks, and duties, because this kind of effort could be circumvented by incumbent directors who have strong incentives to find obedient sheep. Without the institution of derivative action, even the most eager outsiders lack incentives to work hard on behalf of the shareholders. To have genuine outside directors, derivative suits are needed. A country that wants outside directors who are loyal to the shareholders had better elaborate rules on derivative lawsuits than detail requirements on outside directors.

---

38 The latest reform, made at the end of 2001, modified this rule a little bit. It provides that the decision for the company to intervene on the defendant's side shall be approved by all supervisors, Art. 268 para. 8. This new rule, however, seems to be insufficient for overhauling the imbalance that supplementary intervention of a company would cause. The latest reform also assumes supervisors to be official members of a board of directors, and thus obligates them to monitor the decision-making process of the board. See text accompanying notes 58-63 *infra*. Therefore, supervisors are not remote enough from managing directors to make an impartial decision that balances the merits and demerits of the intervention.

39 On criticism of this, see OSUGI (*supra* note 33).

40 See Revised Model Business Corporation Act, Sec. 8.50 *et seq.*; Delaware General Corporation Law, Sec. 145; AMERICAN LAW INSTITUTE (*supra* note 34) at §7.20.

### *3. Complementarity between Derivative Actions and Flexible Company Law*

With the assistance of derivative actions, a nation can deregulate its stock corporation statute because the existence of *ex post* derivative suits does deter inadequate behavior of corporate managers *ex ante*. In Part III 1. c), we surveyed several differences between Japanese and U.S. laws. Here we will see other differences from the perspective of complementarity between shareholders' suits and flexible company codes.

Take traditional rules on in-kind contribution as an example. When a share subscriber pays for her shares with property other than cash, Japanese law requires an inspector (*kensa-yaku*), normally a lawyer, to examine the valuation of the property unless some exceptions apply (Artt. 173, 181, and 280-8 *Shôhô* [Japan's Commercial Code]), because overvaluation of the property harms other subscribers as well as creditors of the company.[41] This rule, however, does not help much if an inspector's valuation is not reliable in the first place. Moreover, even if inspectors do good jobs on the whole, the time and money incurred may outweigh the benefits so that the rule could do more harm than good to shareholders and creditors. In Japan's setting, a court has little incentive to promptly appoint an adequate inspector, just as an appointed inspector has little incentive to appropriately – in other words, at the optimum level – implement his duty.[42] Managers often circumvent the rules by finding a dormant company older than two years, acquiring it, and transferring a part of its business to the acquired, since the rule does not apply to that situation. It must be noted that this way of bypassing the stringent rules is not cost-free: a good deal has to bear the cost that resulted from circumvention, while a bad deal cannot be prevented.

---

41 German law has a similar rule on the inspectors' (*Prüfer*) examination. The author does not mean to criticize German law at this point. Since the performance (efficiency) of this inspection rule depends also on the motivation of inspectors and reputation effects in the professional society, I would like to reserve my opinion on inspectors' examination in Germany.

42 Artt. 177, 189, and 280-14, and Artt. 80 and 82 of *Shôgyô tôki hô* (Commercial Registration Act; Law No. 125/1963, as amended by Law No. 80/2001) attempt to prevent circumvention of the rule: without an inspector's report on in-kind contribution, the register offices do not take in the application of incorporation or increase of registered share capital. Because the procedure takes time and poses unpredictability, the rule makes it difficult for a company to incorporate a subsidiary by contributing a part of its business to it. Until the 1990 reform went into effect on April 1, 1991, companies were able to bypass the rule by setting up a shell company first and then transferring a part of their business to the shell (procrastinated incorporation, *jigo setsuritsu*). Though an attempt was made to shut this loophole by the 1990 reform so that procrastination would not exonerate an inspector's examination (revised Art. 246), room for circumvention still remains as is explained in the following text.
I suspect the reason an inspector is not given adequate incentives is that, although he owes civil liability to the company if the evaluation is inadequate, the representing directors (managing directors) quite rarely sue him, and shareholders are not allowed to bring derivative suits against him. Moreover, the best way of conducting an evaluation has not been seriously discussed from the viewpoint of balancing the time and cost involved on the one hand and its benefit on the other.

U.S. corporate codes do not provide for this kind of inspectors or examination for in-kind contribution. Nevertheless, large-scale businesses usually conduct some sort of professional valuation called "due diligence" when they purchase businesses via mergers or business transfers, regardless of whether the consideration is shares or money, as long as the cost involved is lower than its benefit. While this kind of valuation may be made spontaneously because managers dislike wasting money, it may also be half-forced because managers dislike the risk of being sued and losing the derivative suit, a result that could be reduced by professional valuation. Retained lawyers, accountants, and real estate appraisers have incentives, too, to carry out an appropriate valuation procedure, because they can neglect it only at the risk of being sued by corporate managers who in turn have incentives to sue them to avoid being sued by the shareholders. In that sense, derivative actions better align managerial incentives with shareholders' than elaborate company statutes do. And only remedial rules can effectively avoid managerial circumvention of preventive rules.

Thus, case law has developed a series of directors' rule of conduct, especially in relation to mergers and buyouts. The state of Delaware, in which around half of the public companies in the U.S. were incorporated, is the center for the development of this judge-made law, and the rules are relatively severe in the M & A field, as shown in the famous *Transunion* case.[43] I have an impression that Delaware case law obligates corporate directors, including outside directors, to conduct appropriate discussion and examination before deciding on whether to buy or sell the business and the price of the deal; and whether the conducted discussion and examination was appropriate shall be judged in a cost-benefit analysis, in which essential factors are the size and possible influence and risk of the transaction at hand, and the cost and benefit of a particular information-gathering activity and discussion process. It goes without saying that this impression awaits future verification. If this is the case, although the evolution of the judge-made law is not straightforward and trial-and-error therein makes the rules vague and therefore sacrifices foreseeability of the directors' rule of conduct to some extent, such ambiguous rules are thought to be better than clear-cut rules because they are good at adapting to the changing circumstances.

43 *Smith* v. *Van Gorkom*, 488 A.2d 858 (Sup. Ct. Del. 1985).

## IV. A CAVEAT TO OTHER COUNTRIES IN ADOPTING DERIVATIVE ACTIONS AND OUTSIDE DIRECTORS

With the above discussion in mind, I now turn to the discussion on what the company law reform should be like. Attention will be paid to the institutions of derivative suits and outside directors, and discussions on deregulation of company statues will be omitted.

### *1. On Derivative Suits*

#### *a) Private Actions Are Necessary*

Lawyers from continental European countries and other jurisdictions that inherited continental civil laws tend to show reluctance to adopt derivative suits and private actions generally in their company laws, stating that they would like to avoid a litigious society, that managerial cultures and ethics sufficiently discipline managers in their homeland, and so on and so forth.

However, ethical discipline is not so robust and reliable as it is believed to be; it is heavily dependent upon the economic surroundings. When the national economy goes well and companies are properly run, legal or cultural discipline is not needed very much because managers in that situation have little incentive to steal from the companies or commit self-dealing. But what happens when situations go sour? The Russian economy was hit brutally by the currency crisis in the fall of 1998, and managers at formerly state-owned companies rushed into opportunistic behaviors. Can we be sure the same thing won't happen in a similar situation with a sudden economic depression and weak law enforcement mechanisms in countries that are said to maintain high ethical standards in their managers?[44] I do not think we can at all.

Or civil law lawyers may insist that they adopt some sort of private enforcement mechanism, but that they limit the standing to sue to shareholders owning a certain percentage, such as three percent or one percent. I believe this is not a good idea, either: in large public companies, a mere one-percent requirement would suffocate the very needed private enforcement in the very needed situation. Abusive actions should be curtailed by different means.

#### *b) Civil Law Doctrines May Frustrate Derivative Suits: The Necessity of a Functional Approach*

Although one-percent shareholding should not be required to be a plaintiff, derivative actions are a drastic medicine, and care must be taken in adopting them so as to restrain the medicine from becoming a deadly poison. Japan's experience shown in Part III 2. a) *supra* is a lesson on the inappropriateness of a simple fusion of civil and common laws.

---

44 That is why OSUGI (*supra* note 3) insisted that Russia adopt shareholders' suits coupled with an adequate means of curtailing abusive suits.

It is quite essential to elaborate seemingly technical or peripheral rules in mixing those laws. Some dogmatic and doctrinal approach in civil law tradition may be useless or even harmful in devising a new institution.[45] In addition, the quality of trial judges in an economy is critical in choosing how to deter the misuse of derivative suits; thus, a simple imitation of U.S. rules will not work, either.

A functional approach could be summarized as threefold:

1) to give appropriate – neither too small nor too large – incentives to those who take initiatives – probably lawyers rather than plaintiff shareholders;
2) to give them adequate means to collect information; and
3) to establish proper doctrines and devices in substantive and procedural laws.

First, rules on taxation of litigation costs (*expensae litis*) and the sharing/attribution of attorney's fee (*e.g.,* contingent fee or not) do affect the incentives to plaintiff shareholders and litigation lawyers. Derivative suits are codified in Japan and Canada, but they are not frequently in use because the rules are not appropriate in this regard.[46] It should be noted that rules on costs of litigation in a country, even those in the Anglo-American legal tradition, may need some modification for derivative actions.

Second, shareholders should be entitled to access a company's books and records. It is generally extremely difficult for shareholders to collect information inside the company. If the law does not furnish sufficient access to shareholders, almost all suits to be initiated will be fruitless or pointless. U.S. law has a discovery system in its procedural rules as well as inspection rights to look into a company's books and records in the stock corporation codes. Again, other nations would probably be reluctant to adopt the former, because it seems to go too far and risk companies' trade secrets. But it is not as extraordinary as it looks, since courts are bestowed the "equitable" authority that is backed up by sanctions against "contempt of court," and they can put various limitations and conditions on the plaintiff's exercise of her right, and flexibly implement other measures to manage the situation effectively.[47] If a nation feels it is difficult to

45 It does not, however, mean that there is no need to consult with discussions in Continental Europe. Though German scholars are skeptical about derivative suits and thus share little with the author on that point, their discussions on the limitation of directors' liability against companies and settlements on directors' liabilities seem to be suggestive.

46 In regard to Japan, see M.D. WEST, The Pricing of Shareholder Derivative Actions in Japan and the United States: Northwestern University Law Review 88 (1994) 1436 and M.D. WEST, Why Shareholders Sue: The Evidence from Japan: Journal of Legal Studies 30 (2001) 351. In terms of Canada, See ROMANO (*supra* note 10) at 125 *et seq.*

47 Sec. 37 (1)(4)(c) and Sec. 37 (b) of the Federal Rules of Civil Procedure in the U.S. provide for equitable measures in discovery proceedings. On discovery in derivative suits, see also AMERICAN LAW INSTITUTE (*supra* note 34) at §7.13 (c). On shareholder's inspection of company books and records, see, *e.g.,* Delaware General Corporation Law, Sec. 220 (c). It is noteworthy that courts in the U.S. use sound discretion in imposing conditions on inspection rights. H. KANDA, *Kaikei chôbo-tô no tôsha etsuran-ken* [The Inspection Right of Company Books and Records]: *Jurisuto* 1027 (1993) 24, 25.

adopt this sort of scheme, then an alternative scheme may be worth consideration in which a shareholder may apply to a court to appoint a lawyer and let her inspect the company's books and records, as is often seen in *Konzern* regulations in Europe.[48]

Third, both procedural and substantive rules should be flexible rather than clear-cut. Many rules and doctrines should be properly understood and carefully implanted into the law of each nation; for instance, on the substantive side, in particular the Business Judgment Rule (BJR) and rules on the limitation of directors' liabilities; and, on the procedural side, refined rules on termination of derivative suits, namely rules on adequate representation and the authority of SLCs, dismissal and non-suit, and rules on settlements.

As discussed in Part III 2. a) *supra*, U.S. law gives wide discretion to both judges and outside directors in dealing with derivative cases, but many countries lack either reliable judges or impartial outside directors, or both. In that case, some authority should be delegated to general meetings of shareholders, as illustrated below.

What then should those rules be like in nations where judges are sufficiently reliable? Somewhat ambiguous rules with a list of factors to be counted work better.

Examples are:

> "[W]hen liabilities of a director are at issue, the court shall judge whether the act or omission in dispute was based on the director's rational estimates resulting from appropriate information and time in proportion to the effect the act or omission would cause and its probability. In a case where legitimacy of decision-making within a corporation is at issue, the court shall consider whether the defendant had self-interest in the decision, the quantity and quality of the information she gathered in preparation for the decision, to what extent that information was used in the discussion, as well as other related situations; the result of the decision or other ex-post factors shall not, in principle, be considered, unless they are the obvious reason to support the judgment that the director is not liable (BJR)."[49]
>
> "[I]n a shareholders' derivative action, a plaintiff-shareholder shall adequately represent the best interest of all the shareholders; if the court believes the continuation of the suit is against the best interest of the shareholders, the court may dismiss the case."
>
> "[W]hen a written opinion is presented to the court which recommends termination of the suit, the court may dismiss the case, provided that it looks into the independence of the members of the committee which made the opinion, from the defendant, and the procedure that the committee took for preparing the opinion, and considers the opinion is worth the respect (termination of the derivative suits)."[50]

---

48 *E.g.,* § 315 AktG (German Stock Corporation Act).

49 On BJR, see analyses by AMERICAN LAW INSTITUTE (*supra* note 34) at § 4.01.

50 The standard of judicial review in deciding on the termination is discussed in AMERICAN LAW INSTITUTE (*supra* note 34) at § 7.10.

The auxiliary verb "may" instead of "shall" should be used to make clear the courts' discretion; otherwise, judges in civil law countries might fail to set the frequency of screening out unreasonable cases to the optimum level.

Japan recently introduced an interesting set of rules on limitation of directors' liabilities and settlements of derivative cases. The rule on limitation of directors' liabilities provides that a qualified resolution (*i.e.,* a resolution with special majority of two-thirds votes cast) of the shareholders' meeting may limit liabilities that are thought to have been owed by directors to the corporation (*ex post* limitation), and that a similarly qualified shareholders' resolution may amend the charter of the corporation (articles of incorporation) so that the board of directors may limit director's liabilities (*ex ante* limitation) to the amount specified by the statute as follows: when a liability of an outside director is at issue, the amount is twice the highest amount of annual compensation of that which he received during each past fiscal year and that which he will have received during the present fiscal year from the corporation; in the case of an inside director who is not a representing director, the amount is four times the amount thereof, and in the case of a representing director (managing director), six times; provided that the act or omission was made in good faith and without gross negligence (Art. 266, para. 7-23 *Shôhô*). The new rule on settlements provides that a settlement reached by the plaintiffs and defendants will bind all shareholders if the corporation is a party of the settlement, or if the corporation is not a party thereof, the clauses therein are notified to the company and it does not object to them within two weeks (Art. 268 para. 5-7).

The author believes those new rules are a step in the right direction and deserve attention from abroad, though several modifications should be made to them. The rule on limitation of directors' liabilities is appropriate in delegating to shareholders as a whole body the decision of whether or not liabilities are limited and, if they are, the amount. A limitation involves how to balance the preventive effects and the chilling effects of derivative suits upon managers and directors,[51] and the shareholders as a whole are not only the beneficiaries of derivative suits but also the only party who can be in a position to ultimately decide on it. According to the reform, limitations are capped with two to six times the amount of the defendant's annual compensation, and this is also reasonable, since minimum threats to managers have to be statutorily pre-

51 In regard to the limitation of directors' liabilities, AMERICAN LAW INSTITUTE (*supra* note 34) at § 7.19 should be consulted.
Though the reform referred to in the text is reasonable in its philosophy, several defects have already been pointed out in terms of details. *Ex post* limitation would cause various problems in interpretation of the rule. Less problematic is *ex ante* limitation, but it is difficult to have a well-tuned balance in its future effects: once a limitation clause is inserted into the articles of incorporation, it would be pretty difficult for shareholders to withdraw it. Japanese law coped with this problem by authorizing 3% shareholders to lodge an objection that voids the limitation in regard to a particular cause of liabilities, Art. 266 para. 15 *Shôhô*. It might be better to provide for the expiration of the *ex ante* limitation clause, and thus require shareholders' approval on a regular basis (sunset clause).

served; otherwise, managers would draft settlement clauses that are unconscionably advantageous to them by abusing their predominance in information over shareholders (asymmetric information) and by abusing shareholders' inability to act collectively (collective action problem). However, it is quite essential in the scheme to let the shareholders know of material information to help them vote rationally. The details are expected to be promulgated in a forthcoming administrative rule,[52] but at least one particular piece of information should be included in the disclosure documents to shareholders: whether the directors are insured by directors and officers (D & O) liability insurance, and if they are, the amount to be covered. Without those pieces of information, shareholders could not decide on the limitation, since the amount covered by liability insurance does affect both the preventive and chilling effects on the directors, and therefore this information is critical in balancing them. In addition, those pieces of information should be disclosed continuously as a condition of limitation of liabilities in publicly held corporations.

Even more problematic is the rule on settlements. Settlements in derivative cases should definitely be conditioned upon the court's approval, since the judges are virtually the only persons who can monitor and prevent collusion between the plaintiff and the defendant, or rather collusion between the plaintiff's attorney and the defendant directors, both of whom will be better off from a settlement that favors the attorneys in the sacrifice of the interest of the shareholders as a whole.[53] Also questionable is the rule that a notice of the settlement clauses to the company, not to the shareholders, will restrain other shareholders from attacking the settlement. This may also generate incentives for plaintiff lawyers and defendant directors toward collusive settlements. Common practice will probably be, however, that other shareholders who have interests in preventing collusion will participate in the case as co-plaintiffs, since the new law obligates company whose directors are sued derivatively to publicly announce the fact (Art. 268 para. 4), and therefore provide other shareholders with the chance to participate in it.

Nations whose judges are not sufficiently reliable should modify the proposals that I have mentioned above. The BJR needs few modifications, since judges' discretion in this context will not do enormous harm. The case is the opposite with SLCs and the courts' discretion in dismissing the derivative actions. Some means for dismissing misused suits is necessary, but it should be dependent not upon the courts' discretion but on

52 The Regulation on Disclosure of Documents Attached to the Notice of Convening the Shareholders' Meeting in Large-Sized Stock Corporations (*Dai-kaisha no kabunushi sôkai no shôshû tsûchi ni tenpu subeki sankô shorui-tô ni kansuru kisoku*) is expected to be revised soon.

53 Since it is difficult for a judge to monitor possible collusion between the plaintiff lawyer and the defendant directors, it is assumed that the judge will infer on that account by looking into the substance of settlement clauses. For U.S. practice, see AMERICAN LAW INSTITUTE (*supra* note 34) at §§ 7.14 and 7.15.

resolutions of the shareholders' meeting instead.[54] Limitations of directors' liabilities to the corporation and settlements should also be conditioned on shareholders' approval. Again, full disclosure is the key for shareholders to protect themselves.

### 2. *On Outside Directors*

#### a) *Function and Forms*

Outside directors in publicly held companies are valuable because of their function rather than their appearance. This institution has evolved mainly in U.S. and U.K. practice and is thought to function well in those countries, but it may be difficult for other countries to adopt its form, and/or other forms may be more suitable to them.

The particular form of outside directors as seen in the U.S. and U.K. might have been of historic nature and thus "path-dependent," dependent on the situations that are specific to those economies. Institutional surroundings in the U.S. and U.K. – such as fluid labor markets for corporate managers, heavily regulated banks and other financial intermediaries, and the notion of shareholders' primacy – may all be relevant factors that are different from those of other nations. In terms of the last factor, primacy of shareholders is a common belief as well as the source of boards' dominance over corporate managers in the U.S. and U.K. In Japan, most directors are subordinates of the chief executive officer of the company, and the common belief is that a board of directors is a place for the exchange of business information and opinions and for collective decision-making rather than for monitoring the CEO, other managers, and officers. It is apparent that Japanese firms should do something to improve their governance, but a mere infusion of a couple of outside directors will probably not change the situation in Japan substantially.

A sensible way to realize the functions of outside directors depends on the circumstances in a particular nation, and it is therefore difficult to make a general argument. Here I will present some cautionary notes on this issue.

#### b) *One-Tier Board vs. Two-Tier Board*

Put quite generally, the Anglo-American one-tier board could be compared with the two-tier board in Germany: in the one-tier system, a board's mission is to monitor management, but the board includes the person monitored, *i.e.*, the CEO; in the two-tier system, a supervisory board is distinguished from a management board.

---

54 AMERICAN LAW INSTITUTE (*supra* note 34) at § 7.11 discusses the dismissal of derivative suits based on a shareholders' resolution and other action.
In implementing this approach, a provision is also needed that a shareholders' resolution shall be voidable if the result would have been different except for the votes cast by the defendant directors and the person(s) closely related to them. To be sure, in ruling whether the result would have been the opposite or not, courts are given some extent of discretion, but since the discretion should not be large, that rule causes little risk of bribery to the judges.

In Germany, large debt-holders, the so-called *Hausbank*, traditionally dispatched officers to debtor companies and engaged in monitoring managers in large companies. A hot debate on that system has arisen, and instead of the *Hausbank*, German industries are attempting to establish another external discipline, *i.e.*, the activation of supervisory boards. The Government Commission on the German Corporate Governance Code recently announced a draft code in which the commission rebutted the criticism against the two-tier system, insisting that the dual system and the one-tier board "are practically converging … and are both equally successful." The draft code attempts to improve the two-tier system by introducing cooperation and intensive interaction between the management board and the supervisory board.[55]

Because external discipline is believed to function in German companies, the German system is still evaluated more affirmatively by Western institutional investors than that of Japan. To be sure, an ideal comparison is hard to make, and the above-mentioned reputation might be a product of mere impressions, familiarities, or cultural gaps. Nonetheless, the author still has the impression that most large Japanese corporations lack external disciplines, *i.e.*, monitoring by people who do not belong to the command line from the top to the bottom within a company, and which results in the dismissal of the CEO in extreme situations.

In terms of discipline on managers, neither the one-tier nor the two-tier system *a priori* outperforms the other, and economic surroundings and institutional factors are decisive for the choice between them. Generally speaking, however, information input from the outside is usually better served by the one-tier board than the two-tier board. Now that companies have to compete with each other globally in the rapidly changing environments, the diversified viewpoints, experiences, and expertise that outsiders bring to the board are becoming more and more important. The German experiment of strengthening the interaction between the two boards will attract careful attention in this context.

### c) *Law vs. Best Practice Approach – and Japan's Experiment*

Although self-regulatory organizations (SROs) such as securities exchanges and associations of securities dealers in the U.S. and the U.K. require listed companies to meet board composition standards, statutes there are silent on that issue. SROs in those countries, however, were not purely "spontaneous" when they adopted the requirements; instead, regulatory agencies are said to have exercised their influence on the SROs.

---

55 On December 17, 2001, the Government Commission on the German Corporate Governance Code, chaired by *Dr. Gerhard Cromme,* adopted the draft of a German Corporate Governance Code and announced it to the public. The original (German) version is available at: <*http://www.corporate-governance-code.de/ger/kodex/index.html*> and the English version at: <*http://www.corporate-governance-code.de/eng/kodex/index.html*>.

Nevertheless, the governments tend to refrain from directly intervening in corporate governance by enactment. The German reform plan that I mentioned in Part IV 2. b) *supra* is also in this direction: the draft Corporate Governance Code establishes the goals and rules of conduct for directors and supervisors, but they are not obligatory; according to the draft Code, "Companies can deviate from [the recommendations], but are then obligated to disclose this annually." This sort of interaction between governments and SROs is often called a "best practice approach."

Korea chose to resort to statutes in regulating board composition and obligating large companies to appoint outside directors.[56] In countries such as Korea and Japan – where regulators and regulated entities are too often too close to each other, and the former are often captured by the latter with economic interests – SRO initiatives might not work well. This may explain the statutory approach in Korea. However, "coerced self-regulation" does still have one advantage over the statutory approach: delegating rule-making authorities to SROs enhances awareness of governance in the business society, which cannot be achieved sufficiently by direct intervention of laws. It is necessary to make room for deviation for companies in order to let the securities markets function. A mere statutory approach may lead to a vicious circle in which managers seek to circumvent laws while investors and securities analysts have no chance to develop their screening ability.

Market pressure does decide the extent to which outsider boards work. Statutes and listing agreements can regulate the mere appearance of outsider boards, while only the market pressure can determine whether an adequate person is recruited as an outside director. Regardless of how to introduce the function of external discipline, simultaneous reforms to increase market pressures are absolutely needed, such as imposing fiduciary duties on fund managers of institutional investors with some sanction for its non-observance. A good legislator would not expect too much from stock corporation law alone.[57] Even the most elaborate statute on outside directors may well be in vain by itself.

Japan is moving toward a middle way between the best practice approach and the statutory approach. Rather as the result of political concession, large companies in Japan will be given two alternatives on corporate governance. The first bill, which

56 In Japan, a similar plan of mandating every large company to appoint an outside director was proposed, but this uniform rule met with opposition from the business society, and the new reform adopted a menu approach, as shown in the text accompanying note 64, *infra*.

57 Recall R. GILSON / R. KRAAKMAN, Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate: Stanford Law Review 45 (1993) 985, which, in a quest toward improving U.S. corporate governance with reference to Japan, Germany, and Sweden, argued for eliminating barriers on institutional investors' activities by revising the Investment Companies Act of 1940, rather than mandating a particular form of corporate boards by amending corporate statutes.

recently passed the Diet,[58] strengthens the traditional supervisor system. First of all, it requires three or more supervisors,[59] half of whom must be outsiders.[60] Second, the nomination process of supervisors is improved because it has long been dominated by incumbent managers. In terms of the process of preparing the list of new supervisor candidates, the new rule provides supervisors with a veto against the manager-made list and the ability to replace it with their own to be submitted to a shareholders' meeting that appoints new supervisors.[61] Moreover, supervisors are now considered to be official members of the corporate board. Until the revision, supervisors had been gatekeepers charged with monitoring directors' and employees' compliance with rules and regulations. Their authority extended only to monitoring illegal acts;[62] they were not authorized to monitor the adequacy of directors' management and decisions; they were *authorized* (but *not obligated*) to attend the board meetings and raise questions and objections, but it was thought to be for their above-mentioned monitoring of directors' and officers' compliance. The reform did not change the range of supervisors' authority, and thus they are still confined to monitoring illegal activities. However, the revised rule *obligates* supervisors to attend and raise questions to the board (Art. 260-3 *Shôhô* [The Commercial Code]). We will see what effect this revision will have on Japanese boards. Because this reform attempts for the first time to promote supervisors to official board members, their duty could – and should – be interpreted to encompass monitoring the *process* of the board's meeting as part of their authority to monitor directors' compliance with the Commercial Code that mandates directors, so to speak, to implement due process in managing companies: though supervisors have no authority to vote against a plan submitted by the CEO, they are obligated to raise questions about the decision-making process to prevent managerial imperialism from going too far.[63]

58 This bill was drafted by house members (*Gi'in Rippô*), which is rather uncommon in regard to commercial laws.

59 For English readers, the website of the Japan Corporate Auditors Association offers a primer on the Japanese supervisor system, with sources such as statutes and practices: <*http://www.kansa.or.jp/english/index.html*>.

60 Art. 18 para. 1 of the Act Regarding Exceptional Rules of the Commercial Code Concerning Auditing etc. of Stock Corporations (*Kabushiki kaisha no kansa-tô ni kansuru shôhô no tokurei ni kansuru hôritsu*; Law No. 22/1974, as amended by Law No. 80/2001). Before the revision, only one out of three supervisors had to be an outsider.

61 Art. 18 para. 3 of the Act, *supra* note 60.

62 In this respect, Japanese supervisors and governance rules are totally different from those of Germany, though both use the same term "supervisor".

63 Differences between this upgraded Japanese board and American boards still remain because supervisors do not have voting rights on the boards. This lack of voting authority means supervisors alone cannot remove CEOs, though they are still able to cooperate with directors, inside and outside, for that. Incumbent managers consider this compromising system to be less unacceptable compared to jumping to the American board system, while institutional investors from the U.S. and Europe may be skeptical about it.

It is also expected that another bill will be introduced and passed in the spring of 2002, and this bill will include the American board system as the alternative to the (strengthened) traditional system.[64] It enables a large company to abolish the supervisory system if it adopts a stringent set of rules that require the company to appoint two or more outside directors and set up auditing, compensation, and nomination committees, each of which includes outsiders as a majority. Under this new regime, management and monitoring are clearly separated: the former will be delegated to executive officers and the latter to the board of directors and the three committees. This is a fundamental change from the traditional method of corporate management in Japan as described in Part IV 2. a) *supra*.

It is noteworthy that both alternatives aim at empowering corporate boards, and they share this philosophy with reforms in other countries. Japan is now furnished with a legal framework in which a board can also take up the function of monitoring by substantially introducing outsiders into it. Each company can choose from one of the two, and the choice will be evaluated by the stock markets. Thus, the rule of survival of the fittest will apply to both public corporations and governance rules. Some companies will choose a strengthened supervisory board because it can reduce the potential friction during the transition process as well as utilize accumulated management skills. Other companies that want to appeal to Western institutional investors will adopt the new regime. Whether this ideal scenario will come true will depend on the market pressure. Without a doubt, Japan's experiment will afford other countries a good lesson, whether it is successful or not.

## V. CONCLUDING REMARKS

This paper insists that the global trend of Americanization of stock company laws is basically a move into the right direction, that it is essential to adopt American corporate law as a package rather than in fragments, and that the triangle of

1) elaborately drafted rules on shareholders' derivative suits,
2) introduction of a legal framework that helps external discipline, and
3) deregulating stock corporation statutes

should be the definite strategy of other nations.

In the latter half of this article, I have put special emphasis on the difficulties of introducing derivative actions to countries that have a civil law tradition. Rules on derivative suits should be elaborately drafted and carefully interpreted, and it is not easy

64 The bill was prepared by the Special Committee on Company Laws (*Hôsei Shingi-Kai Kaisha-hô Bukai*), which consists of not only scholars but also practicing lawyers, economists, and some others from the business society.

for civil law theorists and practitioners: doctrinal differences between American and civil law may be an obstacle. How to overcome the difficulties is up to the lawyers in each nation, and the discussion in this paper is not sufficient at all on that point. How to increase market pressure is also not dealt with in this paper. With the lack of these points in mind, the author hopes this paper will contribute to further discussion and research.

ZUSAMMENFASSUNG

*Vor dem Hintergrund einer weltweit zu beobachtenden „Amerikanisierung" des Gesellschaftsrechtes untersucht der Beitrag, welchen Nutzen und welche Schwierigkeiten sich bei einer Rezeption US-amerikanischer Gesellschaftsrechtskonzeptionen für das japanische Recht ergeben. Der Verfasser gibt zunächst einen Abriß über die einschlägige Rechtslage in den USA, wobei er eine institutionelle Komplementarität zwischen der Aktionärsklage (derivative suit) und dem Vorhandensein von externen Mitgliedern des Geschäftsführungsorganes (outside directors) einerseits sowie der wechselseitigen Beziehung zwischen dieser Klageart und einem flexiblen Gesellschaftsrecht andererseits betont. Er entwickelt dabei durchgängig rechtvergleichende Bezüge zum japanischen und deutschen Gesellschaftsrecht. Im Ergebnis begrüßt er das Vordringen bestimmter Konzeptionen des US-amerikanischen Gesellschaftsrechts, warnt aber zugleich davor, einzelne Elemente desselben unreflektiert zu übernehmen. Angesichts einer fehlenden Konvergenz der nationalen Gesellschaftsrechte sei für eine erfolgreiche Rezeption vielmehr eine Übernahme als „Paket" entscheidend, die der analysierten institutionellen Komplementarität Rechnung trage, was im besonderen für Rechtsordnungen von Bedeutung sei, die, wie etwa die japanische, stark durch kontinentaleuropäische Rechtstraditionen geprägt seien.*

*(die Red.)*