

# The Japanization of American Corporate Governance? Evidence of the Never-Ending History for Corporate Law

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I. INTRODUCTION

The debate over corporate governance convergence has been heated for years and has created a cottage industry of experts. It is premised on the false assumption that American corporate governance has reached the end of its evolution by adopting a shareholder primacy and dispersed shareholding governance model.<sup>1</sup> This article demonstrates that

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<sup>1</sup> It is assumed in the corporate governance convergence literature that American corporate governance is based on two fundamental and distinctive features: (1) dispersed shareholding, and (2) shareholder primacy. These features, which have come to be known as the American model, have also been assumed to be the endpoint in the evolution of corporate governance—upon which other systems of corporate governance will (or will not) converge. With respect to dispersed shareholding, Professor Gilson in his 2006 article states: “scholars’ and policymakers’ . . . reactions reflected a teleological view of the evolution of capital markets. They saw a U.S./U.K.-style widely held distribution of stock ownership and control as the endpoint of corporate governance development; progress consisted of accelerating what selection would make inevitable.” Ronald J. Gilson, *Controlling Shareholders and Corporate Governance*, 119 HARV. L. REV. 1641, 1647 (2006) [hereinafter Gilson, *Controlling Shareholders*]. With respect to shareholder primacy, which is the other distinguishing feature of the American model, Professor Bainbridge asserts, “[i]n sum, the literature assumes that the U.S. model, towards which global systems are (or are not) converging, is one of shareholder primacy.” Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT’L LAW 45, 45 (2002). More generally, Professor Gilson in another article notes, “not long thereafter, the Japanese bubble burst and the American economy boomed . . . . The American system then became the apparent endpoint of corporate governance evolution, a consensus that appears clearly from the IMF and the World Bank’s response to the 1997–1998 East Asian financial crisis.” Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 331 (2001) [hereinafter Gilson, *Globalizing Corporate Convergence*]. In a similar vein, Professor Aronson finds that “[w]hile several branches of convergence

American corporate governance continues to evolve and that as such the convergence debate is fundamentally flawed and not worth fixing.

Professors Hansmann and Kraakman's article, *The End of History for Corporate Law*, sets the framework for the current convergence debate.<sup>2</sup> Their argument is twofold: (1) American corporate governance has reached an optimally efficient endpoint by adopting the shareholder primacy and dispersed shareholding corporate model, and (2) the rest of the world will inevitably follow.<sup>3</sup> A litany of scholars have responded to the latter by claiming that path dependence may prevent convergence.<sup>4</sup> However, the former has largely been met with silence.<sup>5</sup> As a result, the convergence debate has been built on the false assumption that American corporate governance has reached a fixed endpoint—upon which convergence will, or will not, occur.<sup>6</sup>

The evidence that the American model is not the end in the evolution of American corporate governance is straightforward: the American model, which is defined by its shareholder primacy and

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theory emerged, by the mid-1990s this debate arguably assumed an underlying tone that 'convergence' meant the rest of the world becoming more like the United States." Bruce E. Aronson, *Reconsidering the Importance of Law in Japanese Corporate Governance*, 36 CORNELL INT'L L.J. 11, 15-16 (2003).

<sup>2</sup> Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001).

<sup>3</sup> *Id.* at 439-40, 452, 457-58, 462-64, 468.

<sup>4</sup> See generally Gilson, *Globalizing Corporate Convergence*, *supra* note 1; John C. Coffee, Jr., *The Rise of Dispersed Ownership*, 111 YALE L.J. 1, 1 (2001); Curtis J. Milhaupt, *The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2125-28 (2001); Mark J. Roe, *Political Preconditions to Separating Ownership from Control*, 53 STAN. L. REV. 539, 539 (2000); Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 127 (1999).

<sup>5</sup> Professor Bainbridge stands out as a lonely voice in challenging the assumption made in the convergence debate that the endpoint American model is based on shareholder primacy. However, Bainbridge does not dispute that the history of American corporate governance has ended, but rather suggests a new ending for the history. He argues that the convergence debate is fundamentally flawed because it assumes that the American model is a shareholder primacy model. He attempts to fix the debate by demonstrating that the endpoint American model is more accurately a director primacy model. In his view, it must be so because director primacy is more efficient than shareholder primacy. Thus, although Bainbridge's analysis is helpful in identifying the false assumption in the convergence literature—that American corporate governance is based on shareholder primacy—it leaves unchallenged the assumption that the American model has finished evolving by adopting an endpoint model. Bainbridge, *supra* note 1, at 45.

<sup>6</sup> See *supra* note 1 and accompanying text.

dispersed shareholding, no longer exists in America.<sup>7</sup> Hostile takeovers, the foundation of shareholder primacy, which transforms “the limited de jure shareholder voice into a powerful de facto form of shareholder control,”<sup>8</sup> are no longer a significant threat for the majority of large American companies.<sup>9</sup> Dispersed shareholding has significantly declined

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<sup>7</sup> It is important to note that the two fundamental aspects of the American model, shareholder primacy and dispersed shareholding, are interrelated. Shareholder primacy requires that shareholders have ultimate control of the corporation. Technically, shareholders wield such control through their voting rights as set out in American corporate law. However, it is widely recognized that in practice voting rights do not provide shareholders with ultimate control. Hostile takeovers have widely been seen as the mechanism that provides American shareholders with ultimate control. Dispersed shareholding is a necessary precondition for an effective hostile takeover regime. Thus, dispersed shareholding is a driving force behind shareholder primacy in the American model. See generally Lucian Arye Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* 14 (Nat'l Bureau of Econ. Research, Working Paper No. 7250, 1999), available at <http://www.nber.org/papers/w7203>; Mike Burkart & Fausto Panunzi, *Takeovers* 25 (ECGI Working Paper Series in Finance No. 118/2006, 2006), available at [http://ssrn.com/abstract\\_id=884080](http://ssrn.com/abstract_id=884080).

<sup>8</sup> John C. Coates IV, *Measuring the Domain of Mediating Hierarchy*, 24 J. CORP. L. 837, 850-51 (1999). As Coffee describes it, “in market-centered economies, the market for corporate control is the ultimate disciplinary mechanism, and the hostile takeover, its final guillotine.” Coffee, *supra* note 4, at 20. The common explanation for why hostile takeovers provide shareholders with ultimate control is that they allow shareholders to effectively monitor and influence management to maximize shareholder value. Hostile takeovers work as a monitoring device by allowing dissatisfied shareholders to sell their shares on the market, which will cause share prices of mismanaged firms to fall. Takeover entrepreneurs or managers at other firms then buy the stock cheaply and, at least according to the theory, improve the target firm’s performance, and finally profit by selling the firm back to the market. The managers’ ever-present fear that they will lose their position if shareholders are dissatisfied with their performance makes them beholden to the wishes of shareholders and thus provide shareholders with de facto ultimate control. Based on this theory, hostile takeovers have come to be viewed as an effective monitoring mechanism providing shareholders with voice and ultimate control. See generally Roe, *supra* note 4, at 558; Gilson, *Controlling Shareholders*, *supra* note 1, at 643 n.1, 643 n.2; Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1223 (2006).

<sup>9</sup> The staggered board and poison pill defense, which increased dramatically in the 1990s, significantly insulated directors and senior executives of the majority of large American companies from the threat of hostile takeovers. Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410 (2005); Lucian A. Bebchuk et al., *The Powerful Anti-takeover Force of Staggered Boards*, 54 STAN. L. REV. 887, 895 (2002). This development has significantly altered the American model, as hostile takeovers (and thus shareholders) are no longer the most important monitoring mechanism. Shareholder primacy has been stifled by removing ultimate control from shareholders. Baird & Rasmussen, *supra* note 8, at 1223-24, 1244; Bainbridge, *supra* note 1, at 49; Zenichi Shishido, *Japanese Corporate Governance*, 25 DEL. J. CORP. L. 189, 220 (2000). Survey evidence demonstrates that lawyers, academics, and the

as institutional investors have replaced individual shareholders in the governance process and some of America's most prominent public companies have adopted controlling shareholder structures.<sup>10</sup> Banks, which are a non-factor in the American model, have usurped hostile takeovers as "the principal mechanism" for replacing management in underperforming firms.<sup>11</sup> These facts turn the convergence debate on its head.

While all eyes remain focused on whether the world is moving towards the American model, America has moved away from it. Ironically, the current American system of corporate governance—with its ineffective hostile takeovers, increase in concentrated shareholdings, and bank monitoring—appears to have moved towards the Japanese main bank model.<sup>12</sup> In the context of the convergence debate, the following question

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business press underestimate the dramatic impact that the poison pill and staggered board defense has on reducing the effectiveness of hostile takeovers. Bebchuk et al., *supra* note 9, at 902.

<sup>10</sup> Since the 1980s, there has been a dramatic shift in the level of dispersed shareholding in the United States. The share of stocks held by individual investors has declined markedly from "70% in 1970 to 60% in 1980 and to 48% in 1994." Bengt Holmstrom & Steven Kaplan, *The State of U.S. Corporate Governance* 14 (European Corporate Governance Institute, Finance Working Paper No.23/2003, 2003). At the same time, large financial institutions have acquired block shareholdings. Between 1980 and 1996, large institutional investors increased their share of ownership of U.S. corporations from "less than 30% to more than 50%." Paul A. Gompers & Andrew Metrick, *Institutional Investors and Equity Prices*, 116 Q.J. ECON. 229, 239 (2001). Some scholars suggest that institutional shareholders provide shareholders with more power and control than they would otherwise have as individual stockholders. To the contrary, institutional investors have their own interests (i.e., making money for institutional shareholders) which do not necessarily reflect those of shareholders. Moreover, there is no conclusive empirical evidence to support that they provide shareholders with an increased level of ultimate control. Bainbridge, *supra* note 1, at 50-53, 57-59. In a recent article, Professor Gilson highlights a number of facts that demonstrate that American shareholding is less dispersed than is commonly assumed (even without considering the rise in institutional block shareholders). Gilson, *Controlling Shareholders*, *supra* note 1, at 1660.

<sup>11</sup> Baird & Rasmussen, *supra* note 8, at 1212, 1243-44. This is in spite of the common view in the literature that the American model has "a large number of comparatively small banks that for practical purposes play no role in corporate governance, and an advanced stock market that supports an active market for corporate control catalyzed by the mechanism of hostile takeovers." Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 342. Baird and Rasmussen explain how the literature has neglected to identify the significant role that banks have come to play in American corporate governance. They thus describe banks as "the missing lever" in the corporate governance analysis. Baird & Rasmussen, *supra* note 8, at 1212-16.

<sup>12</sup> The classic Japanese governance model is based on banks being the most important monitors, with hostile takeovers and other shareholder-based monitoring

logically arises: Is American corporate governance converging on the Japanese main bank model?

In short, the answer is no. However, this misses the point. The Japanese main bank model, which many viewed as *the* endpoint model two decades ago, also no longer exists.<sup>13</sup> After almost a decade of resisting change, the main bank model was significantly altered when the Japanese government decided to phase out its no-fail bank policy.<sup>14</sup> This change helped drive Japanese banks and companies to finally address the economic problems that had been festering since the bubble burst.<sup>15</sup> It has

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playing almost no role. The other two key components of the model are cross-shareholding (*keiretsu*) and lifetime employment, which both act to insulate management from external market-based monitoring. See generally Masahiko Aoki, *The Japanese Main Bank System: An Introductory Overview*, in THE JAPANESE MAIN BANK SYSTEM 1-50 (Masahiko Aoki & Hugh Patrick eds., 1994) (providing a concise explanation of the classic Japanese main bank model); Dan W. Puchniak, *The 2002 Reform of the Management of Large Corporations in Japan*, 5 AUSTL. J. ASIAN L. 42, 46 (2003).

<sup>13</sup> See generally Curtis J. Milhaupt, *A Lost Decade for Japanese Corporate Governance Reform?* 1 (Colum. Law Sch. Working Paper Series, Working Paper No. 234, 2003), available at <http://ssrn.com/abstract=442960> (providing a concise overview of some recent reforms to the Japanese main bank model).

<sup>14</sup> See generally Curtis Milhaupt, *Japan's Experience With Deposit Insurance and Failing Banks*, 77 WASH. U. L.Q. 399, 399 (1999) (detailed review of the no-fail policy in postwar Japan until the late 1990s); Takeo Hoshi & Anil K. Kashyap, *Solutions to Japan's Banking Problems: What Might Work and What Definitely Will Fail* 17-19 (Aug. 27, 2004) (draft manuscript presented at the U.S.-Japan Conference on the Solutions for the Japanese Economy, June 2004), available at <http://www.esri.go.jp/jp/workshop/040903/040903Kashyap.pdf> (analyzing how the government's no-fail policy continued even into the early 2000s); Dan W. Puchniak, *Perverse Main Bank Rescue in the Lost Decade*, 16 PAC. RIM L. & POL'Y 13, 42-59 (2007); Masami Imai, *Market Discipline and Deposit Insurance Reform in Japan* 1 (Ctr. on Japanese Econ. & Bus. Working Paper Series, Working Paper No. 234, 2005) available at [http://digitalcommons.libraries.columbia.edu/japan\\_wps/9/](http://digitalcommons.libraries.columbia.edu/japan_wps/9/) (offering empirical evidence that in the early 2000s the initial unlimited coverage under the deposit insurance plan and the government's continued forbearance policy contributed to shielding banks from market forces); Zenichi Shishido, *Changes in Japanese Corporate Law and Governance: Revisiting the Convergence Debate* 1, 5-6 (Univ. of Cal. Berkeley, Law and Econ. Workshop, Working Paper No. 1, 2004), available at [http://repositories.cdlib.org/berkeley\\_law\\_econ/Fall2004/1/](http://repositories.cdlib.org/berkeley_law_econ/Fall2004/1/).

<sup>15</sup> Following the burst of the stock market and real estate bubbles, Japanese banks were confronted with crippling levels of nonperforming loans. One would have expected for these loans to be written off and for underperforming companies to be culled from the market. Astonishingly, over the course of the lost decade, NPLs in Japan actually increased—despite massive injections of capital from the government. Kaoru Hosono & Masaya Sakuragawa, *Bad Loans and Accounting Discretion* 29 (Nov. 26, 2005) (unpublished manuscript), available at <http://fhayashi.fc2web.com/conf/domestic%20macro%2005.htm>. In a recent article, Peek and Rosengren provide empirical evidence that, rather than writing off

also contributed to the current economic recovery, which has produced the longest sustained period of postwar economic growth in Japan.<sup>16</sup> The convergence debate has largely overlooked the importance of this development, as it was neither a movement towards nor away from the American model.<sup>17</sup> Rather, phasing out the no-fail bank policy was a successful adaptation of Japanese corporate governance. Empirical evidence confirms that Japan's failure to adapt its corporate governance sooner contributed to its lost decade (1990–2002) of economic growth.<sup>18</sup>

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nonperforming loans to underperforming client firms, main banks systematically chose to continue to lend to underperforming clients throughout the lost decade. This behavior, known as evergreening was supported by the Japanese government's forbearance, no-fail bank policy. Joe Peek & Eric S. Rosengren, *Unnatural Selection: Perverse Incentives and the Misallocation of Credit in Japan* 95 AM. ECON. REV. 1144, 1144-45, 1164-65 (2005); see also Puchniak, *supra* note 14; Richard J. Caballero et al., *Zombie Lending and Depressed Restructuring in Japan* 28-29 (Working Paper, 2006), available at [http://econ-www.mit.edu/faculty/download\\_pdf.php?id=1241](http://econ-www.mit.edu/faculty/download_pdf.php?id=1241); Hosono & Sakuragawa, *supra*, at 8-9; Takeo Hoshi & Anil Kashyap, *Japan's Financial Crisis and Economic Stagnation*, 18 J. ECON. PERSP. 3, 7-9, 14-15 (2004). It was not until the early 2000s, once the government had instituted a more credible bank closure policy and began enforcing it, that evergreening began to end, nonperforming loans decreased, and large-scale creative destruction of inefficient firms finally occurred. Bank of Japan, *An Assessment of Financial Stability: Focusing on the Banking Sector*, Financial System Report 30 (Aug. 2005), available at <http://www.boj.or.jp/en/type/ronbun/fsr/data/fsr05a.pdf>; Peek & Rosengren, *supra*, at 16; *Time to Arise from the Great Slump*, ECONOMIST, July 22, 2006, at 72-73 [hereinafter *Great Slump*]; *Japan's Banks: Genesis*, ECONOMIST, Sept. 10, 2005, at 31 [hereinafter *Genesis*]. Although the government continued some of its forbearance policies into the 2000s, it sent a strong message to the banking industry that underperforming banks may be closed by allowing Japan's tenth-largest bank and fourth-largest securities firm to fail in 1997. Imai, *supra* note 14; Milhaupt, *supra* note 14, at 418-19. In addition, the creation of the FSA in 1999 helped break the cozy relationship between banks and their former regulator the MOF. There is also evidence that post-2000, the FSA regulators have in fact been more diligent in enforcing banking regulations and forcing banks to write off nonperforming loans to zombie firms. Peek & Rosengren, *supra*, at 16; *Great Slump*, *supra*, at 72-73; *Dead Firms Walking*, ECONOMIST, Sept. 23, 2004, at 77, 77-79 [hereinafter *Dead Firms*].

<sup>16</sup> *Great Slump*, *supra* note 15, at 72-73; *Japan's Economic Recovery: Depends on Where You Are*, ECONOMIST, May 6, 2006, at 9 [hereinafter *Economic Recovery*].

<sup>17</sup> The removal of the no-fail bank policy was not a movement towards or away from the American model because bank monitoring is not a part of the American model. Therefore, altering the incentives that banks have to monitor finds no point of comparison in the American model. An example of a movement towards or away from the American model would be changes in Japan's hostile takeovers market or concentrated shareholding structure.

<sup>18</sup> Puchniak, *supra* note 14, at 36-39.

While Japan's inflexibility was its downfall, America's ability to adjust its corporate governance to fit its ever-changing economic requirements has been its success.<sup>19</sup> In the 1980s, when American firms were grossly underperforming, the shareholder primacy model used hostile takeovers to effect much-needed restructuring.<sup>20</sup> In the 1990s, firms adopted a more stable director primacy model, which limited hostile takeovers and increased the discretion of directors, to allow firms to take advantage of their restructuring gains.<sup>21</sup> During this era, banks arose as another governance mechanism for controlling agency costs—the consequences of which cannot be determined yet.<sup>22</sup> However, whatever the result of the rise in American bank monitoring, the point that emerges from American and Japanese corporate governance is that there is no magic in any particular governance model. Whatever economic magic exists in corporate governance is the result of effectively adapting corporate governance to fit its ever-changing environment.<sup>23</sup>

From this perspective, the relevance of the convergence debate, with its obsessive focus on optimally efficient endpoint models, fades in

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<sup>19</sup> Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 131, 136 (2001).

<sup>20</sup> As Professors Holmstrom and Kaplan note:

Another reason why the 1990s merger wave differed from the 1980s wave likely has to do with different stages of the restructuring process. In the 1980s, restructuring was just beginning. The focus was on forcing corporate assets out of the hands of managers who could not or did not want to use them efficiently. The results included takeovers and restructurings of companies with excess capacity as well as bust-up takeovers of inefficient conglomerates. Hostility and leverage were important accompaniments. The 1990s appear to have been more of a build-up wave with assets reconfigured to take advantage of growth opportunities in new technologies and markets.

*Id.*

<sup>21</sup> *Id.*; see also Bainbridge, *supra* note 1, at 59-61 (providing an analysis of the positive role played by director discretion, particularly in the late 1990s and early 2000s).

<sup>22</sup> Baird & Rasmussen, *supra* note 8, at 1251.

<sup>23</sup> It should be noted that there is still a more general debate concerning whether there is any link between corporate governance and economic performance. The evidence is still unclear. See generally Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAWYER 921, 921 (1999) (offering a broad review of the existing empirical studies in the United States).



importance.<sup>24</sup> At its most basic level, the convergence debate is about predicting the future: Will the world converge on a single, optimally efficient endpoint model? If we accept that corporate governance does not develop towards a fixed endpoint, whether two models appear closer to or farther from each other at a given time tells us little. This is because at any time in the future the models may backtrack, cross paths, or move in new unexpected directions. As such, the convergence debate should be abandoned.<sup>25</sup>

The fact that effective corporate governance rests on the ability of a governance system to adapt, rather than on any particular model, also has serious practical implications for underperforming and transitional economies. The last decade has seen the American model exported to countries around the world in order to improve their economic performance. However, if the American model is not fixed, and in fact changes before it is even implemented in other countries, the efficiency gains of the American model may be lost, even in the face of perfect implementation.

A model is merely a snapshot of the governance mechanisms in existence at a given point in time.<sup>26</sup> Focusing on this snapshot places undue importance on the existing governance mechanisms and misses the importance of the system that allowed the mechanisms to arise at the correct time in the first place.<sup>27</sup> Unfortunately, policymakers do not embrace this approach. The adaptive process is much more complicated to identify and package for export than static models. We must begin to accept the complexity of the real world if we want to understand how corporate governance works within it. In this age of globalization, where change increasingly occurs at a rapid rate, the study of comparative

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<sup>24</sup> Aronson, *supra* note 1, at 53 (recognizing the futile focus on best models of the convergence debate).

<sup>25</sup> Professor Milhaupt, in a recent article, also expressed skepticism about the utility of the convergence debate. Curtis J. Milhaupt, *In the Shadow of Delaware? The Rise of Hostile Takeovers In Japan*, 105 COLUM. L. REV. 2171, 2213-14 (2005); *see also* Aronson, *supra* note 1, at 56.

<sup>26</sup> Professor Aronson has recognized the limited use of models in the convergence debate: “[f]irst, comparisons of corporate governance systems tend to be influenced by underlying assumptions or value judgments concerning which is the ‘best’ or ‘model’ system. Views on which system is the proper ‘model’ may change over time depending on the economic performance and perceived ‘success’ of various countries.” Aronson, *supra* note 1, at 53-54; *see also* Shishido, *supra* note 9, at 220.

<sup>27</sup> Professor Aronson has reservations about the convergence debate because of its “tendency to oversimplify governance systems into static ‘idealized’ models, such as the ‘Anglo-Saxon’ model and the ‘European/Japanese’ model, which can readily be used to make broad international comparisons.” Aronson, *supra* note 1, at 54.

corporate governance should focus on explaining what allows a system of corporate governance to efficiently adapt to its ever-changing environment.<sup>28</sup>

The balance of this article will proceed as follows. Section II will examine the convergence debate and will demonstrate that it is based on the false assumption that the American model has finished evolving. Section III will describe the evolution of American corporate governance over the last two decades to illustrate that its success is the result of its adaptation, not its strict adherence to the American model. Section IV will examine the lost decade of Japanese corporate governance to remind today's endpoint scholars of the fallibility of endpoint assumptions and to explain how Japan's failure to adapt, not its choice of the wrong model, contributed to the economic malaise of the lost decade. Section IV will also briefly analyze how Japan's more recent adaptation of its main bank system has driven a new era of economic expansion. Finally, Section V will conclude by explaining why the convergence debate should be abandoned and comparative corporate governance should instead focus on understanding the forces that drive efficient adaptation.

Before moving on, a preliminary point must be made regarding the ahistorical nature of the convergence debate. Several scholars point to the increasing level of globalization from the late 1980s as uniquely impacting convergence.<sup>29</sup> They assert that it was not until globalization came about that a true international competition emerged in which systems of corporate governance could compete.<sup>30</sup> Additionally, some scholars suggest that the American model did not crystallize before the late 1980s.<sup>31</sup> Obviously, limiting history to after the late 1980s makes it much

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<sup>28</sup> See generally Jack B. Jacobs, *Some Lessons From Delaware's Experience in Crafting "Fair" Takeover Rules*, 2 N.Y.U. J. L. & BUS. 323, 337, 350 (2006) (providing a similar view); Shishido, *supra* note 9, at 221; Gilson, *Controlling Shareholders*, *supra* note 1.

<sup>29</sup> As noted by Professors Milhaupt and West, "The potential effects of globalization have emerged as a central focus of the corporate law and governance debate." Curtis J. Milhaupt & Mark D. West, *Institutional Change and M&A in Japan: Diversity Through Deals* 3 (U. Mich., John M. Olin Center for Law & Econ., Research Paper No. 01-010, 2001), available at <http://papers.ssrn.com/abstract=290744>.

<sup>30</sup> Hansmann & Kraakman, *supra* note 2, at 450; Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations From Japan and The United States*, 150 U. PA. L. REV. 527, 534 (2001); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2074 (2001) [hereinafter Roe, *Shareholder Wealth*]; James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 CORNELL INT'L L.J. 31, 32 (1998); Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1994 (1993) [hereinafter Roe, *Differences in Corporate Structure*].

<sup>31</sup> Milhaupt, *supra* note 13, at 29.

easier to claim that the American model has reached the endpoint. After all, America has been the world's sole economic superpower and is commonly viewed as having had the world's most efficient economy since that time. However, to avoid falling prey to the uniqueness of globalization claim, this paper focuses on the period from the late 1980s to the present and shows that even during this time the American model has evolved away from the supposed endpoint. The fact that the American model has changed its core features in this relatively short and prosperous period of time reinforces the main theme in this article: continuous adaptation, not a static model, is the hallmark of efficient corporate governance.

## II. THE CONVERGENCE DEBATE

### A. *The Development of the Endpoint Assumption: Why Path Dependence Is to Blame*

The most important aspect of any debate is how the question is framed. When the question is based on a false assumption, the debate is moot. We all realize the problematic assumption in the question: Will the world end today or tomorrow? However, somehow in the complexity of the convergence debate we seem to have forgotten that the debate is premised on an unproven assumption: American corporate governance has reached its evolutionary end.<sup>32</sup>

This assumption was not always part of the debate. Indeed, in the era when Japan had the largest stock market in the world and the value of the grounds of the Imperial Palace in Tokyo was equal to that of California, some saw Japan's main bank model as the logical endpoint.<sup>33</sup>

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<sup>32</sup> The convergence debate is not new to comparative corporate governance. Indeed, the debate surrounding the convergence of civil and common law systems was active in the 1970s. However, it appears that for corporate law, the forces of globalization in the 1980s and 1990s created a new genre in the literature, which was driven by the increase in cross-border competition. Rather than corporate law being merely descriptive, it evolved into an analysis of which model or system of corporate governance (if any) would ultimately win this global competition. In this article, this new era of corporate governance scholarship is referred to as the convergence debate. West, *supra* note 30, at 534.

<sup>33</sup> TAKATOSHI ITO, *THE JAPANESE ECONOMY 3-5* (1992); *Great Slump*, *supra* note 15, at 72. In the early 1990s, before the scope of Japan's economic problems became clear, Aoki and several other scholars suggested that transitional economies should structure their reforms based on the Japanese main bank model, rather than the American market-based model. Masahiko Aoki & Hugh Patrick, *Introduction*, in *THE JAPANESE MAIN BANK SYSTEM*, *supra* note 12, at xxi-xxxii; Hoshi et al., *Financial System Reform in Poland: Lessons for Japan's Main Bank System*, in *THE JAPANESE MAIN BANK SYSTEM*, *supra* note 12, at 593-630. Also, in the early 1990s, Michael Porter credited the Japanese bank centered model with allowing companies to efficiently focus

The assertion that American corporate governance might be forced to abandon its shareholder primacy and dispersed shareholding model, was at least open for debate. Then, the bubble burst.<sup>34</sup> The suggestion that Japan's main bank model was the endpoint in the evolution of corporate governance quickly faded.<sup>35</sup>

It did not take long for American evolutionists to claim victory.<sup>36</sup> Well before the scale of Japan's economic woes were revealed, claims that

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on enhancing long-term growth. He contrasted this with what he saw as the shortsighted approach forced on American managers by fickle myopic markets dominated by hostile takeovers. Michael Porter, *Capital Disadvantages: America's Failing Capital Investment System*, HARV. BUS. REV. (1992). See generally Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUS. & CORP. CHANGE 277, 297-313 (1996) (summarizing the academic literature favoring bank-centered corporate governance).

<sup>34</sup> Hoshi & Kashyap, *supra* note 15, at 5-6; GILLIAN TETT, SAVING THE SUN 62-63 (2003); *Passing Go*, ECONOMIST, Oct. 9, 2004, at 73. From 1990 to 1991, asset prices declined rapidly in Japan. The Nikkei 225 stock price index reached its 38,915 peak on the last business day of 1989 and then collapsed. By October 1, 1990, the Nikkei hovered barely above 20,000—a decline of almost 50 percent in 9 months. It then floated around the 15,000 level for the balance of the 1990s, with some considerable fluctuations. The Nikkei entered the new millennium with a brief climb up to 20,000 and then plummeted again to its postwar low of 7,607 on April 28, 2003—which was less than 20 percent of its bubble peak. Most observers consider 2003 as the end of the lost decade. Since that time, a recovery has been in progress. At the time of writing this paper, the Nikkei stands around 15,000. Land prices began to fall in late 1991, and by 1995 prices were half of their peak values. They continued to fall for 15 straight years until 2005. At the time of writing this paper, it appears that land prices are slowly starting to climb. Michael Hutchison et al., *Empirical Determinants of Banking Crisis: Japan's Experience in International Perspective*, in WHY DID JAPAN STUMBLE? 157, 157 (Craig Freedman ed., 1999); Hoshi & Kashyap, *supra* note 15, at 5; *Great Slump*, *supra* note 15, at 72-73.

<sup>35</sup> Professor Gilson notes that “[b]efore the bursting of the Japanese ‘bubble economy,’ the main bank system represented the future . . . . Not long thereafter, the Japanese bubble burst and the American economy boomed. . . . The American system then became the apparent endpoint of corporate governance evolution.” Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 331. Professors Miwa and Ramseyer also note that by the end of the lost decade, “within Japan many scholars . . . [were] suggest[ing] using the law to dismantle the ‘main bank system.’ Adopt instead, they argue[d], the classic governance arrangements involving director and shareholder oversight.” Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC. INQUIRY 401, 409 (2002); see also Curtis J. Milhaupt, *On the (Fleeting) Existence of the Main Bank System and Other Japanese Economic Institutions*, 27 LAW & SOC. INQUIRY 425, 428 (2002).

<sup>36</sup> Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 331; see also Roe, *Differences in Corporate Structure*, *supra* note 30, at 1935, 1965. The term “American evolutionist” is used in this paper to refer to the faction of scholars who posit that by adopting the dispersed shareholding and shareholder primacy governance model, the United States became the first country to reach the endpoint in the evolution of corporate governance and that the rest of the countries in the world will inevitably follow.

the American model was the inevitable evolutionary endpoint in corporate governance emerged.<sup>37</sup> The argument of American evolutionists was straightforward. The American model of corporate governance, marked by shareholder primacy and dispersed shareholding, was the most efficient system in the world.<sup>38</sup> By adopting its chosen model, America had reached the end in the evolution of corporate governance first and the rest of the world would inevitably follow.<sup>39</sup> In the minds of American evolutionists, to say that America would one day adopt key features of the Japanese main bank model (e.g., bank monitoring or concentrated shareholding) was tantamount to saying that humans would one day return to living in the jungle as apes.

America's undeniable economic success in the 1990s provided new persuasive evidence for the American evolutionist theory—but the essence of the claim remained the same. Professors Hansmann and Kraakman's provocative article, *The End of History for Corporate Law*, is the most noted recent articulation of the American evolutionist point of view.<sup>40</sup> In their article, Hansmann and Kraakman boldly claim that “the triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured.”<sup>41</sup> In fact, in their world, the convergence debate has essentially ended, as “most of corporate law” around the globe has already converged on the American model.<sup>42</sup>

Hansmann and Kraakman's claim sparked a strong, even emotional, reaction. One prominent American scholar asserts that these

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<sup>37</sup>According to Professor Aronson, “[w]hile several branches of convergence theory emerged, by the mid-1990s this debate arguably assumed an underlying tone that ‘convergence’ meant the rest of the world becoming more like the United States.” Aronson, *supra* note 1, at 15-16; see also Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 331; Roe, *Differences in Corporate Structure*, *supra* note 30, at 1935, 1965.

<sup>38</sup>Professor Roe in his 1993 article summarizes the position of American evolutionists at that time as believing that large firms in every economy “would face agency problems” and be forced to “catch up” to America by adopting the dispersed shareholding and shareholder primacy model. He further summarizes the evolutionist position as asserting “that corporate ownership mediated through securities markets is the highest form of financial development, successfully providing ownership, diversification, and liquidity in just the right proportions.” Roe, *Differences in Corporate Structure*, *supra* note 30, at 1934-35.

<sup>39</sup>*Id.*; Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 331.

<sup>40</sup>Hansmann & Kraakman, *supra* note 2.

<sup>41</sup>*Id.* at 468.

<sup>42</sup>“The basic law of corporate governance—indeed, most of corporate law—has achieved a high degree of uniformity across developed market jurisdictions, and continuing convergence toward a single, standard model is likely.” *Id.* at 439.

“academic elites” have “fall[en] in love with [their] own ideas” and shown “hubris” by claiming that “there is only one way—the American way.”<sup>43</sup> The validity of such criticism is debatable. However, one cannot accuse Hansmann and Kraakman of being vague. They positively assert that the American model, defined by shareholder primacy and dispersed shareholding, has reached an optimally efficient endpoint and that the rest of the world will inevitably follow.<sup>44</sup> This is the same argument that other American evolutionists made a decade earlier.<sup>45</sup>

The flaw in the convergence debate is *not* the result of the bold position taken by American evolutionists, but rather the increasingly hedged response to it. In the early 1990s, the response to the American evolutionist claim of inevitable convergence was two pronged: (1) the Japanese and American models were equally efficient solutions to their countries’ unique governance problems, and (2) the American model was itself transforming to adopt some efficient aspects of the Japanese/German bank-centered models.<sup>46</sup> That the American model was *the* most efficient model of corporate governance in the world, or even *the* most efficient model for America, was not assumed. Indeed, it was rejected. The important underlying assumption was that the American model would continue to change—it was not static.<sup>47</sup> However, as the 1990s progressed, the response to American evolutionists changed.

The 1990s were marked by the indisputable rise of the American economy and the equally apparent demise of Japan and Germany’s economic fortunes.<sup>48</sup> This evidence clearly demonstrated the effectiveness of the American model and illuminated the flaws in the competing Japanese and German governance models.<sup>49</sup> Under the weight of these realities, it appears that the response to American evolutionists began to waffle. Scholars no longer positively asserted that the American model had not reached an optimally efficient endpoint. In fact, in many cases, the opposite was assumed: the American model was the end in the

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<sup>43</sup> Douglas M. Branson, *The Very Uncertain Prospect of “Global” Convergence in Corporate Governance*, 34 CORNELL INT’L L.J. 321, 322-23, 332-33, 347 (2001).

<sup>44</sup> Hansmann & Kraakman, *supra* note 2, at 439-40, 452, 457-58, 462-64, 468.

<sup>45</sup> Roe, *Differences in Corporate Structure*, *supra* note 30, at 1934-35; *see also* Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 331.

<sup>46</sup> Roe, *Differences in Corporate Structure*, *supra* note 30, at 1930, 1934.

<sup>47</sup> *Id.* at 1932.

<sup>48</sup> Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 331.

<sup>49</sup> As Professor Milhaupt notes, “by the end of Japan’s ‘lost decade’ of recession and stagnation in the 1990s, many analysts were ready to relegate Japan’s distinctive institutions to the junk heap of economic history.” Milhaupt, *supra* note 35, at 428.

evolution of corporate governance. The only point of contention was whether the rest of the world would inevitably follow.<sup>50</sup>

The literature explaining why the rest of the world would not follow or had not followed is complex. However, virtually all of the arguments fall within the rubric of a basic theory known as path dependence.<sup>51</sup> Professor Coffee explains path dependence as a theory based on the belief that “history matters, because it constrains the way in which institutions can change, and efficiency does not *necessarily* triumph.”<sup>52</sup> Coffee contrasts this with the evolutionist theory which asserts that “as markets globalize and corporations having very different governance systems are compelled to compete head to head . . . a Darwinian struggle becomes likely, out of which . . . the most efficient form should emerge dominant.”<sup>53</sup> On its face, path dependence does not axiomatically lead to endpoint conclusions. To the contrary, it suggests that historical constraints often compel countries to adopt suboptimal governance models that must continually be adjusted to account for ever-changing institutional forces.

However, this is not the manner in which scholars have applied the path dependence theory. Increasingly, path dependence has been used to explain why other countries’ systems of corporate governance have failed to adopt the American model.<sup>54</sup> The obvious, and often unstated assumption, is that America’s history has enabled it to adopt the optimally efficient American model, while the histories of all other countries in the world (except perhaps England) have constrained them.

That the convergence debate assumes the American model is the endpoint of corporate governance is reflected in the narrowed scope of the current path dependence debate. The debate has been reduced to whether

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<sup>50</sup> Coffee, *supra* note 4; Milhaupt, *supra* note 4, at 2125-28; Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 330-31; Roe, *supra* note 4; Jeffrey N. Gordon, *Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany*, 5 COLUM. J. EUR. L. 219, 219 (1999). *See generally* Gilson, *Controlling Shareholders*, *supra* note 1, at 1647; Bainbridge, *supra* note 1, at 45; Aronson, *supra* note 1, at 15-16.

<sup>51</sup> Gilson, *Controlling Shareholders*, *supra* note 1, at 1644. *See generally* Bebchuk & Roe, *supra* note 4 (providing a concise overview of the path dependence theory).

<sup>52</sup> Coffee, *supra* note 4, at 4 (emphasis added).

<sup>53</sup> *Id.* at 3.

<sup>54</sup> Coffee, *supra* note 4; Milhaupt, *supra* note 4, at 2125-28; Gilson, *Globalizing Corporate Convergence*, *supra* note 1; Roe, *supra* note 4; Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1151 (1998). *See generally* Gilson, *Controlling Shareholders*, *supra* note 1, at 1647.

historical constraints in other countries can persist despite being pressured by efficiency to adopt the American model.<sup>55</sup> Whether the foundational characteristics of the American model—shareholder primacy and dispersed shareholding—will change is no longer a question. It is widely assumed that they will not.<sup>56</sup> Humans do not become apes.

It is not often that one side of a hotly debated legal issue concedes a critical point by simply assuming that it is true. As such, the balance of this section will provide detailed evidence that both of the fundamental components of the American model, dispersed shareholding and shareholder primacy, are assumed in the literature to be efficient endpoints. It will also explain how the endpoint assumption has infected one of the more nuanced branches of the convergence debate, the formal versus functional dichotomy, and has crept into the Japanese comparative corporate governance literature to form the basis for recent corporate governance reforms in Japan and transitional economies.

*B. The Convergence Debate Assumes Dispersed Shareholding Is the Endpoint*

Recently, the primary focus of the convergence debate has been explaining America's unique status as a country with dispersed shareholding.<sup>57</sup> In its pure form, the dispersed versus concentrated shareholding debate considers the relative advantages and disadvantages of each shareholding system on their own and in comparison to each other.<sup>58</sup> Again, such a debate does not appear to readily lend itself to the assumption that the American model is the endpoint in the evolution of corporate governance. After all, it normally defines the United States and the United Kingdom as the only dispersed shareholding systems in the world.<sup>59</sup> To the uninitiated this suggests that, if an endpoint were to be predicted, the best bet would be for America to join the other 99 percent of countries and adopt a concentrated shareholding system.

However, path dependence theory has been used to explain America's ascendance to dispersed shareholding which, as explained above, has been a common method for introducing the American endpoint assumption into the convergence debate. Taking a path dependence

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<sup>55</sup> Coffee, *supra* note 4; Milhaupt, *supra* note 4, at 2125-28; Gilson, *Globalizing Corporate Convergence*, *supra* note 1; Roe, *supra* note 4; La Porta et al., *supra* note 54.

<sup>56</sup> Gilson, *Controlling Shareholders*, *supra* note 1, at 1647; Bainbridge, *supra* note 1, at 45; Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 331.

<sup>57</sup> Gilson, *Controlling Shareholders*, *supra* note 1, at 1642-43.

<sup>58</sup> *Id.* at 1643.

<sup>59</sup> *Id.* at 1645-46.



approach, the literature has sought to explain two features in the dispersed versus concentrated shareholding dichotomy: (1) why America won the race to the optimally efficient dispersed shareholding system, and (2) why historical constraints have prevented all other countries (except England) from adopting the optimally efficient dispersed shareholding system.<sup>60</sup>

The literature provides a colorful array of path dependent explanations to answer these questions. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (LLS&V) credit America's status as a common law country with its ability to win the race to dispersed shareholding.<sup>61</sup> They claim that civil law countries provide inadequate protection for minority shareholders, which explains their inability to reach the endpoint.<sup>62</sup> Professor Roe rejects LLS&V's argument and instead suggests that America's socially conservative government was the critical competitive advantage that allowed it to win the race to dispersed shareholding.<sup>63</sup> In Roe's view, "social democracies stymie diffuse ownership," which explains why other developed countries have failed to reach the dispersed shareholding endpoint.<sup>64</sup> Professor Coffee continues the debate by claiming that both LLS&V and Roe have missed the mark.<sup>65</sup> He suggests that America won the race to dispersed shareholding largely because the American government allowed "enlightened self-regulation" of U.S. markets in the late 1800s.<sup>66</sup> In Coffee's opinion, the "paternalistic supervision" of markets by other countries' governments has frozen the development of dispersed shareholding.<sup>67</sup>

Although each of the theories contradict the other, they are all based on the assumption that dispersed shareholding marks the end in the evolution of corporate governance. From this, it logically follows that dispersed shareholding is an immutable feature of the American model. After all, there is no reason for America to rid itself of dispersed shareholding if it is optimal.

The path dependent reasons that each author selects to explain the development of America's dispersed shareholding system further

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<sup>60</sup> *Id.* at 1647-48.

<sup>61</sup> La Porta et al., *supra* note 54, at 1145-51.

<sup>62</sup> *Id.* at 1145-51.

<sup>63</sup> Roe, *supra* note 4, at 593, 601-02.

<sup>64</sup> *Id.* at 593.

<sup>65</sup> Coffee, *supra* note 4, at 5-11.

<sup>66</sup> *Id.* at 9-11.

<sup>67</sup> *Id.* at 9.

reinforces the assumption of its immutability. America's common law legal system, rejection of social democracy and promotion of self-regulation go to the core of American culture and democracy. That any of these features will change in the foreseeable future is inconceivable to the authors. That dispersed shareholding may not be an immutable feature of modern American corporate governance escapes the debate.

The assumption that dispersed shareholding is the endpoint in the evolution of corporate governance has risen beyond a mere academic debate. The International Monetary Fund and World Bank made this assumption in their response to the 1997 Asian Financial Crisis.<sup>68</sup> These institutions made financial assistance conditional on countries adopting corporate governance reforms which generally promoted the American model and more specifically promoted dispersed shareholding.<sup>69</sup> These conditions only make sense if the International Monetary Fund and World Bank believed that America's economic success is a result of the American model using dispersed shareholding. Since the 1980s, America has adopted a more concentrated shareholding structure, which in many respects is similar to the Japanese main bank model. This adaptation in the American model appears to have been overlooked by the International Monetary Fund and the World Bank when they forced the American model of dispersed shareholding on struggling countries.

*C. The Convergence Debate Assumes Shareholder Primacy Is the Endpoint*

That shareholder primacy marks the end in the evolution of corporate governance is also rarely questioned.<sup>70</sup> Since the mid-1990s, the

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<sup>68</sup> Gilson, *Controlling Shareholders*, *supra* note 1, at 1647-48.

<sup>69</sup> John M. Broder, *Asia Pacific Talks Vow Tough Action on Economic Crisis*, N.Y. TIMES, Nov. 26, 1997, at A1; Timothy Lane et al., *IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment* 72-73 (Int'l Monetary Fund, Occasional Paper No. 178, 1999), available at <http://www.imf.org/external/pubs/ft/op/op178/OP178.pdf>. See generally Gilson, *Controlling Shareholders*, *supra* note 1.

<sup>70</sup> Professor Bainbridge, upon reviewing the literature, states:

Although participants in the convergence debate disagree as to whether international corporate governance is converging on the U.S. model, there is general agreement as to the nature of that model. Henry Hansmann and Reinier Kraakman argue, for example, that corporate governance systems around the world are converging "towards 'the standard shareholder-oriented model' of the corporate form," which they assert has always been the dominant model in the United States and the United Kingdom. In contrast, while Roberta Romano expresses skepticism about the extent of (and the desirability of) global corporate governance convergence, she too assumes that U.S. jurisdictions tend

convergence debate has been framed on the assumption that if convergence occurs it will be on the American shareholder primacy model.<sup>71</sup> As such, whether shareholder primacy has remained a fundamental characteristic of the American model does not enter into the convergence debate.

Professor Bainbridge's recent article, *Director v. Shareholder Primacy in the Convergence Debate*, is a notable exception.<sup>72</sup> He astutely observes that the convergence debate is fundamentally flawed because it "assumes that the U.S. model, towards which global systems are (or are not) converging, is one of shareholder primacy."<sup>73</sup> However, he then repeats the more fundamental error in the literature by assuming that American corporate governance has finished evolving by adopting an endpoint model—the director (not shareholder) primacy model. Bainbridge's mistake is that he does not dispute that the history of American corporate governance has ended, but merely rewrites the ending of history with director primacy as its lead actor.<sup>74</sup> Indeed, Bainbridge suggests that his redefinition of the endpoint fixes the convergence debate. In his view, it is correct to assume that the American *director primacy* model is the model on which global systems will (or will not) converge.<sup>75</sup> As the next section shows, this is an error.

Despite this error, Bainbridge's article has significant value. It correctly identifies one of the false assumptions of the convergence debate—that the American model is a shareholder primacy model.<sup>76</sup> It also accurately describes the reasons why the American model, at the time Bainbridge wrote his article in 2001, was largely a director primacy model.

However, the American model was not based on director primacy in the late 1980s and early 1990s. At that period, hostile takeovers gave shareholders ultimate control of corporations.<sup>77</sup> In addition, Bainbridge

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"to adopt laws that maximize shareholder wealth." In sum, the literature assumes that the U.S. model, towards which global systems are (or are not) converging, is one of shareholder primacy.

Bainbridge, *supra* note 1, at 45.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 45, 59-62.

<sup>75</sup> *Id.* at 61-62.

<sup>76</sup> *Id.* at 45.

<sup>77</sup> Bainbridge bases his discussion of shareholder primacy on the fact that ultimate shareholder control is an essential feature of the shareholder primacy model.

fails to make any mention of the increasing significance of banks in American corporate governance. Therefore, although Bainbridge's analysis makes many of the critical points to rebut the shareholder primacy assumption, it does nothing to address the fundamental flaw in the convergence debate.

*D. The Formal/Functional Dichotomy Supports the Endpoint Assumption*

Professor Gilson's distinction between formal and functional convergence is cited as an example of an alternative approach to the convergence debate that avoids the endpoint assumption.<sup>78</sup> I disagree. Gilson's formal/functional dichotomy merely adds another layer of complexity to the endpoint assumption and illustrates how even the most nuanced of approaches to convergence assumes that the American model has reached a fixed endpoint.<sup>79</sup>

According to the formal/functional dichotomy, although the mechanisms of corporate governance systems may differ in their form, they may nevertheless be functionally equivalent. To prove this, Gilson relies heavily on the empirical finding that despite "the striking [formal] differences" between the American, Japanese and German governance models they all perform the essential function of replacing underperforming management with equal efficiency (i.e., the tenure of senior management in all three countries is equally sensitive to poor performance).<sup>80</sup> In Gilson's view, each system "within their path

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This is not disputed in the literature. He also places significant importance on hostile takeovers as a mechanism that has the potential to increase shareholders' control. However, he concludes that hostile takeovers merely serve as a disciplining mechanism and not a control mechanism. I disagree. Hostile takeovers are a disciplining mechanism when they are active, but also serve as a control mechanism when they are not undertaken. The threat of hostile takeovers functions as a constant controlling mechanism over managers because they are forced to manage in the interest of shareholders as they remain in the shadow of the threat of being taken over on a daily basis. Bainbridge admits to the power of hostile takeovers by stating, "takeover defenses—especially the combination of a poison pill and a classified board—go a long way towards restoring director primacy vis-à-vis the shareholders." *Id.* at 49. I agree with this statement. Indeed, this is why in the late 1980s a shareholder primacy model existed—at that time hostile takeover defenses had not fully developed and therefore hostile takeovers were much more of a threat.

<sup>78</sup> Shishido, *supra* note 9, at 218, 218 n.131.

<sup>79</sup> Gilson, *Globalizing Corporate Convergence*, *supra* note 1.

<sup>80</sup> *Id.* at 338.

dependent limits” is able to find functional equivalents without changing its form.<sup>81</sup>

The fundamental claim of the formal/functional dichotomy is that a model’s functional performance (e.g., how efficiently it replaces underperforming managers) ultimately determines whether it will change. A model will retain its form if, without having to change that form, it can achieve efficient functional solutions to its governance problems.<sup>82</sup> Gilson is emphatic that formal change only occurs “as a last resort” because formal change requires “changing complimentary institutions,” which is costly.<sup>83</sup>

Thus, in Gilson’s formal/functional world, there is little reason to suggest that the American model’s formal market-based monitoring mechanism (i.e., hostile takeovers and absence of bank monitoring) would have changed during the 1990s.<sup>84</sup> After all, there is nothing to suggest that American corporate governance faced a situation of last resort during this time. To the contrary, America’s economic performance during the 1990s suggests that its corporate governance was functionally efficient, if not optimal.<sup>85</sup> However, America’s monitoring mechanisms did in fact significantly change during the 1990s as American corporate governance marginalized hostile takeovers and increasingly relied on banks to monitor management. This suggests that formal change may occur even when functional equivalents exist and that Gilson’s theory of rigid formal models is misleading.

Gilson’s acceptance of the American model as formally fixed is further illustrated in his explanation of what he calls “failures of functional convergence.”<sup>86</sup> According to Gilson, a failure of functional convergence occurs when a governance system cannot adapt within its governance mechanisms to achieve a functionally equivalent solution to a governance problem.<sup>87</sup> In his article that sets out the formal/functional dichotomy, Gilson suggests that bank centered governance models have recently

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<sup>81</sup> *Id.*

<sup>82</sup> As stated by Gilson, “[t]his analysis suggests a pattern: Functional convergence is likely the first response to competitive pressure because changing the form of existing institutions is costly. New institutions require new investment, and existing institutions will have developed related interest groups that render more difficult any necessary political action.” *Id.*

<sup>83</sup> *Id.* at 336.

<sup>84</sup> *Id.* at 342.

<sup>85</sup> *Id.* at 336.

<sup>86</sup> *Id.* at 342-46.

<sup>87</sup> *Id.*

experienced a failure of functional convergence as they have been unable to find a functional equivalent for the American model's efficient market-based venture capital system. The conclusion is that bank systems will be forced to formally change.<sup>88</sup> However, Gilson does not mention any comparable functional failures that may require the American model to formally change.<sup>89</sup> To the contrary, Gilson notes that even through the restructuring in the 1980s, the American model surpassed expectations in its ability to maintain its form.<sup>90</sup>

Gilson even suggests a reason why the American model has achieved a functional endpoint. He asserts that the American model is the result of an internal competition between the corporate governance systems offered by each state in America.<sup>91</sup> Functional optimality may thus be the result of America finishing its Darwinian corporate governance battle by selecting Delaware corporate governance as its endpoint model.<sup>92</sup>

*E. The Endpoint Assumption Shapes Japanese Corporate Governance*

The assumption that the American model has reached its endpoint has seeped into the literature that considers the last decade of Japanese corporate governance reforms. It has become common for most examinations to start by asking whether Japanese corporate governance has converged on the American model.<sup>93</sup> Simply framing the debate in

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<sup>88</sup> "The empirical evidence needed to assess the existence of functionally equivalent financing of innovation in bank-centered systems is not available, but anecdotal evidence supports a skeptical view." *Id.* at 344.

<sup>89</sup> *Id.* at 342-46.

<sup>90</sup> "In fact, American manufacturers adopted lean production, but adapted lean production to fit their governance institutions, rather than adapting their institutions to lean production . . . . The American system's functional adaptivity proved to be greater than expected, leaving institutional form largely intact. Thus, the debate over convergence is not quite joined." *Id.* at 332.

<sup>91</sup> *Id.* at 350.

<sup>92</sup> "Because in the United States a corporation's internal affairs (including especially its corporate governance) is governed by its state of incorporation without regard to its principal place of business, a U.S. corporation can choose the state corporate law that governs its affairs by choosing its state of incorporation. The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law." *Id.* at 350.

<sup>93</sup> Luke R. Nottage & Leon T. Wolff, *Corporate Governance and Law Reform in Japan: From the Lost Decade to the End of History?* (CLPE Research Paper No. 3, 2005), available at <http://ssrn.com/abstract=830005>; Milhaupt, *supra* note 13; R. Daniel Kelemen & Eric C. Sibbitt, *The Americanization of Japanese Law*, 23 U. PA. J. INT'L ECON. L. 269, 269 (2002).

this fashion creates the false impression that the American model is fixed. Indeed, such examinations define the American model very broadly as being based on shareholder primacy and market-based monitoring that is facilitated by dispersed shareholding.<sup>94</sup> This is an error because American corporate governance has significantly evolved away from these features over the last two decades.

Perhaps more disconcerting is that some of the literature not only assumes that the American model is fixed, but that it is the end in the evolution of corporate governance. Even Professor Milhaupt, deservedly regarded as one of the most respected comparative and Japanese law scholars, appears to make this assumption.<sup>95</sup>

In a recent article on norms in Japanese corporate governance, Milhaupt directly responds to two of Hansmann and Kraakman's American evolutionist claims: (1) that there has been global convergence on shareholder primacy as a normative view of corporate structure and governance, and (2) that substantial convergence in the practice of corporate governance and in corporate law will follow.<sup>96</sup> Milhaupt provides numerous reasons for why Hansmann and Kraakman's claim of inevitable convergence "may be overstated."<sup>97</sup> However, one of the reasons that Milhaupt provides to make this point reveals his implicit (and perhaps unintentional) acceptance of the endpoint assumption. As Milhaupt explains, "there is no reason to believe that corporate governance norms around the world are poised to yield uniformly to a

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<sup>94</sup> Professors Nottage & Wolff in their recent article set out to "assess claims of Americanization of Japanese law by critically examining the recent raft of reforms to Japanese corporate governance." They define the American model broadly as the "US model dominated by shareholder interests and arms length relationships." They do not provide a detailed explanation of how the American model has evolved over the last two decades—and (aside from one footnote) treat it as essentially fixed and also as understood by the reader. Nottage & Wolff, *supra* note 93, at 3, 36. Similarly, Milhaupt in a recent article that examines the reforms made to Japanese corporate law and practice during the lost decade, refers to "U.S. practices" without any in-depth discussion of what those practices are or how those practices have changed. Milhaupt, *supra* note 13, at 11, 31. To be clear, by proceeding in this fashion the authors of these articles are in fact reflecting the mainstream approach in the convergence literature—that the U.S. model is commonly understood as being based on shareholder primacy and dispersed shareholding and that the model is static.

<sup>95</sup> In the view of a prominent Japanese law scholar, and this author, Professor Milhaupt is one of two "doyens of this 'Next Generation'" in Japanese law scholarship. Kent Anderson, *The Next Generation: Milhaupt And West On Japanese Economic Law*, 27 MICH. J. INT'L L. 985, 986 (2006).

<sup>96</sup> Milhaupt, *supra* note 4, at 2125-28.

<sup>97</sup> *Id.*

*more efficient* [American shareholder primacy] set of norms.”<sup>98</sup> The statement assumes that the American shareholder primacy norm is more efficient. Milhaupt concludes the article by stating: “For the economic and political actors in *these* countries [Japan and other transitional economies, but not America], it is not the end of history, but the beginning of time.”<sup>99</sup> This suggests that all other countries are only about to start the corporate governance race while America is sitting at the finish line. Again, the only question considered is which countries will join America in embracing the endpoint American model.

The endpoint assumption, which has colored the academic debate, has also shaped the government’s approach to recent corporate governance reforms.<sup>100</sup> In an attempt to address its economic malaise in the 1990s, Japan extensively revised its corporate law.<sup>101</sup> These legal reforms have largely been sold as Americanizing Japanese corporate governance.<sup>102</sup> For example, legal reforms have been made to remove barriers to derivative actions, simplify merger procedures, permit employee stock options, and allow companies to adopt American-style boards.<sup>103</sup> Although these legal changes have had a limited impact on Japanese corporate governance practice, the government’s perception of a fixed endpoint American model undoubtedly shaped the direction of reform.<sup>104</sup> This is clear from the fact that the reforms all appear to be attempts to implement aspects of the

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<sup>98</sup> *Id.* at 2127 (emphasis added).

<sup>99</sup> *Id.* at 2128 (emphasis added).

<sup>100</sup> Professor Dore paints a vivid picture of the general perspective taken towards recent reforms:

What . . . all these slogans [concerning Japanese capital market reform] add up to is a general belief that (1) the principles according to which the typical neoclassical economics textbook says the economy ought to work are a priori correct principles, (2) those principles are best exemplified in the American economy, (3) the rightness of those principles is further confirmed by American success, and (4) Japan's present plight is not just a cyclical phenomenon and a debt-deflation hangover from the bubble; it is the natural and wholly just retribution visited on Japan for not following those principles.

Ronald Dore, *Japan's Reform Debate: Patriotic Concern or Class Interest? Or Both?*, 25 *J. JAPANESE STUD.* 65, 66 (1999).

<sup>101</sup> See generally Milhaupt, *supra* note 13, at 4-11.

<sup>102</sup> Puchniak, *supra* note 12, at 43, 64-65, 71, 72 n.3.

<sup>103</sup> Milhaupt, *supra* note 13.

<sup>104</sup> See Puchniak, *supra* note 12, at 43, 64-65, 71, 72 n.3 (explaining the approach that the Japanese government took in revising the law to allow companies the option to adopt American-style boards).



American model. That the American model no longer exists has scanty entered into the reform debate.

### III. THE EVOLUTION OF AMERICAN CORPORATE GOVERNANCE

#### A. *One Model of American Corporate Governance Does Not Exist*

Although those immersed in the convergence debate have largely assumed that American corporate governance has been frozen in time since the era of globalization began in the late 1980s, the entire American academy has not taken this approach. Indeed, the academy has not been twiddling its thumbs for the past two decades assuming that corporate governance has remained the same. To the contrary, it has been busier than ever tracking the changes.

Scholars are familiar with Professor Bebchuk's research demonstrating that the poison pill and staggered board defense has dramatically reduced the threat of hostile takeovers (and thus shareholder primacy).<sup>105</sup> That the rate of dispersed individual shareholding has substantially declined as institutional investors have acquired concentrated block shareholdings and large American companies have adopted controlling shareholding structures is far from a secret.<sup>106</sup> That banks have arisen as a critical monitoring mechanism has recently been the focus of two leading American law professors.<sup>107</sup> Indeed, within the past two years, these fundamental changes have been reported in the most prestigious U.S. law journals.<sup>108</sup> The disconnect between the evidence that the American model has fundamentally changed and the static picture of the model painted in the convergence literature is obvious.

There are a number of potential reasons for the disconnect. From a cynical perspective, those engaged in the convergence debate may prefer to ignore the changes because recognizing them would make the debate moot. Without fixed models and an endpoint, the broader convergence debate is meaningless. To examine whether two models appear closer to

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<sup>105</sup> See Bebchuk & Cohen, *supra* note 9, at 410; Bebchuk et al., *supra* note 9, at 895 (providing examples of Bebchuk's research); see also Baird & Rasmussen, *supra* note 8, at 1243 n.117; Bainbridge, *supra* note 1, at 31 (providing examples of scholars recognizing the importance of Bebchuk's findings).

<sup>106</sup> See generally Scheherazade S. Rehman, *Can Financial Institutional Investors Legally Safeguard American Stockholders?*, 2 N.Y.U. J. L. & BUS. 683 (2006); Holmstrom & Kaplan, *supra* note 10; Holmstrom & Kaplan, *supra* note 19; Gompers & Metrick, *supra* note 10; Gilson, *Controlling Shareholders*, *supra* note 1, at 1660.

<sup>107</sup> Baird & Rasmussen, *supra* note 8.

<sup>108</sup> Gilson, *Controlling Shareholders*, *supra* note 1; Baird & Rasmussen, *supra* note 8; Bebchuk & Cohen, *supra* note 9.

or farther from each other at a given point in time tells us little, since at any time the models may backtrack, cross paths, or move in entirely new and unexpected directions. To argue about whether to export the American model when the American model will have changed before it is even exported seems futile. In this light, it is easy to imagine how the endpoint assumption survives on academic self-interest and policymakers' lust for neatly packaged solutions to the difficult economic problems of transitional economies.

However, there is evidence to support a less cynical view. There may be the legitimate belief that, while some change has obviously occurred, the foundational characteristics of the American model, shareholder primacy and dispersed shareholding, have largely remained the same. Indeed, a recent survey of lawyers, academics, and the business press demonstrates that they all grossly underestimate the extent to which the poison pill and staggered board defense has insulated management from hostile takeovers and thus significantly eroded shareholder primacy.<sup>109</sup> The rise in concentrated block shareholding by institutional investors is often viewed as increasing shareholder voice and control, when empirical evidence suggests the opposite.<sup>110</sup> Similarly, even though the rising power of banks over American directors and senior management is well documented in the bankruptcy literature, its implications for corporate governance have only recently been illuminated.<sup>111</sup> In this sense,

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<sup>109</sup> "We interviewed fifteen senior partners from major law firms in New York City and Wilmington, Delaware and found consensus around the view that targets, once in play, will generally trade to either the initial bidder or to a white knight. When presenting drafts of this Article, we also surveyed M&A practitioners and corporate law academics to get their quantitative assessment of the impact of staggered boards on bid outcomes. Among M&A lawyers, the mean estimate for likelihood of remaining independent increased by only 5% when the target had an effective staggered board. Among corporate law academics, the mean estimate for the likelihood of remaining independent increased by 9%. As we will show . . . the actual effect is several times larger than these estimates." Bebchuk et al., *supra* note 9, at 891, 902.

<sup>110</sup> See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994) (providing examples of the assertion that the increase in institutional investors will increase shareholder control); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 530-34 (1990) [hereinafter Black, *Shareholder Passivity*]; see also Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, in *The New Palgrave Dictionary of Economics and the Law* 459, 461-62 (1998) [hereinafter Black, *Shareholder Activism*] (providing an overview of the empirical evidence demonstrating that institutional investors do not increase shareholder control). See generally Bainbridge, *supra* note 1, at 50.

<sup>111</sup> "Even while creditor control has yet to hit the radar screen of the general corporate governance literature, it has become the central issue in bankruptcy scholarship. One can already find academics bemoaning the power that senior creditors

the assumption that the American model finished evolving almost two decades ago may lie in the convergence debate's failure to integrate new research into its analysis and instead rely on general stereotypes of American corporate governance, which are false.

The fundamental elements of the American model, shareholder primacy and dispersed shareholding, have dramatically changed since the late 1980s. In fact, the changes have been so significant that the American model has developed many features of the Japanese main bank model, which is often viewed as its antithesis. The point that emerges is that if any of America's recent economic success is attributable to its corporate governance, it is because of its effective adaptation and not its strict adherence to a static model.

B. *The Decline of Hostile Takeovers: Why Shareholder Primacy No Longer Exists*

Shareholder primacy is based on the premise that shareholders "exercise ultimate control of the corporate enterprise."<sup>112</sup> Technically, shareholders are given ultimate control under American corporate law through the exclusive right to elect directors to the board.<sup>113</sup> However, it is well recognized that the election of directors is predetermined by the existing board's nomination of next year's board.<sup>114</sup> This fact, combined with a myriad of other more technical restrictions on shareholder voting rights, has led to the conclusion that voting rights "are so weak that they scarcely qualify as part of [American] corporate governance."<sup>115</sup>

The absence of shareholder control through voting rights has placed the mechanism of hostile takeovers at the center of the American shareholder primacy model.<sup>116</sup> Hostile takeovers are viewed as the

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exercise in reorganizations today. These critiques neglect the connection between creditor control and corporate governance as a general matter." Baird & Rasmussen, *supra* note 8, at 1242.

<sup>112</sup> Bainbridge, *supra* note 1, at 48.

<sup>113</sup> *Id.* at 48-49.

<sup>114</sup> As Baird & Rasmussen note, "[s]hareholders nominally have the right to elect directors, but given the dispersion of shares, the board is effectively self-perpetuating." Baird & Rasmussen, *supra* note 8, at 1214.

<sup>115</sup> Bainbridge, *supra* note 1, at 48.

<sup>116</sup> As Gilson asserts,

The market for corporate control can force a widely held firm to internalize change; nothing plays a similar role in a controlling shareholder regime save the market mechanism, which in an efficient controlling shareholder system can be expected to operate rather slowly because of the absence of the financial drain of tunneling.

mechanism that transforms “the limited de jure shareholder voice into a powerful de facto form of shareholder control.”<sup>117</sup> Indeed, within the context of the convergence debate, hostile takeovers are consistently viewed as *the* central mechanism that provides shareholders with ultimate control.

Professor Coffee, in his often cited article on convergence, refers to the market for corporate control as “the ultimate disciplinary mechanism” and hostile takeovers as “its final guillotine.”<sup>118</sup> In the same vein, Professor Gilson, in his article explaining the formal/functional convergence dichotomy, asserts that the commonly held view of the American model is that it is “catalyzed by the mechanism of hostile takeovers.”<sup>119</sup> The fact that the American model has an effective hostile takeover regime is used to both distinguish it from other models and as a litmus test to determine how far countries have or have not moved towards the endpoint American shareholder primacy model.<sup>120</sup> Yet again, since the early 1990s, while scholars have been fixated on measuring convergence, it appears that the dramatic change in America’s hostile takeovers regime, which directly effects whether shareholders have ultimate control, has been forgotten.

The fact that hostile takeovers provide American shareholders with ultimate control over corporations is a relic of the 1980s.<sup>121</sup> This paper does not dispute that hostile takeovers *were* the driving force in the 1980s in American corporate governance, which gave shareholders ultimate control. Indeed, the restructuring of American corporations in the 1980s

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Gilson, *Controlling Shareholders*, *supra* note 1, at 1679.

<sup>117</sup> Coates, *supra* note 8, at 850-51; Baird & Rasmussen, *supra* note 8, at 1223.

<sup>118</sup> Coffee, *supra* note 4, at 20.

<sup>119</sup> Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 342.

<sup>120</sup> This approach can be seen in Hansmann and Kraakman’s statement:

Hostile takeovers are rare outside the Anglo-American jurisdictions, principally owing to the more concentrated patterns of shareholdings outside those jurisdictions. As shareholding patterns become more homogeneous (as we expect they will), and as corporate culture everywhere becomes more accommodating of takeovers (as it seems destined to), takeovers presumably will become much more common in Europe, Japan, and elsewhere.

Hansmann & Kraakman, *supra* note 2, at 457-58; *see also* Roe, *supra* note 4, at 558; Milhaupt & West, *supra* note 29, at 3, 30.

<sup>121</sup> Holmstrom and Kaplan, *supra* note 10.

was defined by hostile takeovers, as over half of all major American companies received hostile takeover bids.<sup>122</sup>

Although the efficiency of hostile takeovers was hotly debated at the time, a consensus has now emerged that the takeovers of the 1980s maximized shareholder value and served as an efficient monitoring device.<sup>123</sup> Efficiency aside, it is beyond dispute that hostile takeovers were a threat to almost every director and manager in America in the 1980s.<sup>124</sup> The threat of disenchanted shareholders selling their shares to takeover entrepreneurs or competing firms shaped the decisions of directors and managers. In short, hostile takeovers in the 1980s provided shareholders with ultimate control, which today is still assumed to be the fundamental characteristic of the American shareholder primacy model.

The impact of hostile takeovers was dramatically reduced in the 1990s because of the substantial increase in corporations implementing effective takeover defenses, most importantly the staggered board and poison pill defense. In the late 1980s and early 1990s, judicial and statutory developments made the poison pill an effective defense against hostile takeovers as incumbent directors were given “substantial freedom to maintain a pill indefinitely.”<sup>125</sup> Therefore, hostile bidders were effectively prevented from acquiring a controlling block of shares beyond the pill’s trigger level. The entrenchment of the pill in American corporate governance significantly reduced the threat of *direct* hostile takeovers in the 1990s.

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<sup>122</sup> *Id.*

<sup>123</sup> *Id.* at 127; Roe, *supra* note 4, at 558; Gilson, *Controlling Shareholders*, *supra* note 1, at 1643 n. 1, 2. As stated in a recent article by Professors Burkart & Panunzi:

More importantly, hostile takeovers are a mechanism to discipline managers and thereby address problems raised by the separation of ownership and control. Indeed, a functioning takeover market is the most direct way to achieve control contestability which many commentators consider an essential component of an effective governance system (Berglöf et al., 2003). In recent years, this view has also gained support among European regulators and politicians, as the discussions surrounding the European Takeover Directive show. In particular, the European Commission and its expert group sought to open up Europe for takeovers to promote restructuring. According to the Commission, Europe badly needs more restructuring if it wants to accomplish the goal, set forth in the 2000 Lisbon Declaration, to become the world’s most dynamic economic region.

Burkart & Panunzi, *supra* note 7, at 2-3.

<sup>124</sup> Roe, *Shareholder Wealth*, *supra* note 30, at 2074.

<sup>125</sup> Bebchuk & Cohen, *supra* note 9, at 412.

However, the pill is an incomplete defense.<sup>126</sup> A hostile bidder can work around a pill by having a team of pro-takeover directors who agree to redeem the pill elected to the target board. The hostile bidder can do this by putting an attractive offer on the table, which will induce shareholders to select the pro-takeover directors in a proxy contest at the annual general shareholders' meeting.<sup>127</sup> This indirect method of takeovers prompted target companies in the 1990s to adopt staggered boards to block the loophole in their hostile takeovers defense.<sup>128</sup>

The adoption of a staggered board created an impenetrable defense to indirect hostile takeovers, thus closing the loophole in takeover defenses. When a company adopts a staggered board, only a third of the directors are reelected each year.<sup>129</sup> Therefore, for a bidder to have a majority of their pro-takeover directors elected via proxy contest takes more than a year (two elections). No hostile bidder has ever persisted long enough to win two elections.<sup>130</sup> Thus, American companies that adopted staggered boards in the 1990s completed their defense to hostile takeovers.

It is noteworthy that the indirect method of conducting a hostile takeover, working around the pill via proxy contest, is supported by shareholder advocates and the courts, who view it as "the safety valve on which takeover law has relied to protect shareholder interests."<sup>131</sup> The rationale is that, by allowing shareholders to vote on the takeover bid, their ultimate control over the corporation is secured. Whether it is efficient to provide shareholders with ultimate control is debatable, but the important point for this analysis is that by adopting a staggered board companies remove the "safety valve" protecting shareholder control and the influence of hostile takeovers is significantly reduced.

A recent article by Bebchuk, Coates, and Subramanian confirms the effectiveness of the poison pill and staggered board defense as a means

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<sup>126</sup> *Id.* at 413.

<sup>127</sup> *Id.*

<sup>128</sup> *Id.* at 411-15.

<sup>129</sup> Bebchuk, Coates, and Subramanian summarize how staggered boards work under American law as follows:

The default law in all states requires that all directors stand for election at each annual shareholder meeting. However, all states provide an exemption from this requirement if the board is staggered. In a company with a staggered board, directors are grouped into classes (typically three), with each class elected at successive annual meetings.

Bebchuk et al., *supra* note 9, at 893.

<sup>130</sup> Bebchuk & Cohen, *supra* note 9, at 413.

<sup>131</sup> Bebchuk et al., *supra* note 9, at 891.

of insulating directors from shareholder control.<sup>132</sup> During the five-year period of their study (1996–2000), they found that the staggered board and poison pill defense almost doubled the chances of a target corporation remaining independent.<sup>133</sup> This finding provides empirical support for the theory that the poison pill and staggered board defense effectively insulates directors from hostile takeovers and thus, significantly reduces shareholder control.

The number of companies that adopted staggered boards dramatically increased throughout the 1990s. In 1990, only 34 percent of firms that went public had staggered boards. By 2001, the number had increased to over 70 percent.<sup>134</sup> By the mid-1990s, the increase in the adoption of staggered boards resulted in over 60 percent of all large U.S. public companies having staggered boards.<sup>135</sup> Bainbridge suggests that the minority of companies that did not adopt staggered boards failed to do so because they already had sufficient takeover defenses.<sup>136</sup> That by the mid-1990s, the majority of large U.S. public companies were effectively insulated from the threat of hostile takeovers was a staggering development in American corporate governance.

As the 1990s progressed, not only did hostile takeovers become increasingly less relevant for the majority of U.S. firms, but the number of hostile takeover attempts also dramatically declined. In the hostile environment of the 1980s, it is estimated that between 20 percent and 40 percent of total tender offers were contested, compared to 15 percent or fewer in the 1990s.<sup>137</sup> This decline in hostile takeover activity is confirmed by a recent comprehensive study of hostile takeovers in the last five years of the 1990s, which found only ninety-two hostile bids during that time. This is in stark contrast to another study that found 1,032 hostile bids from 1985 to 1990.<sup>138</sup> The small number of bids in the last

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<sup>132</sup> *Id.*

<sup>133</sup> *Id.*; see also Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 793 (2002) (summarizing Bebchuk et al.'s findings).

<sup>134</sup> Bebchuk et al., *supra* note 9, at 889.

<sup>135</sup> Bebchuk & Cohen, *supra* note 9, at 419.

<sup>136</sup> Bainbridge asserts, “[p]erhaps public corporations lacking a staggered board do not need one as a takeover defense, because they have other strong takeover defenses in place (such as the existence of a friendly controlling shareholder or dual class stock).” Bainbridge, *supra* note 133, at 802.

<sup>137</sup> Holmstrom and Kaplan, *supra* note 19, at fig.6.

<sup>138</sup> Bebchuk et al., *supra* note 9, at 925; Katsumoto Iwai, *Persons, Things and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance*, 47 AM. J. COMP. L. 583, 608-09 (1999). Commenting on Bebchuk’s

five years of the 1990s is dwarfed by the number of large firms that filed for Chapter 11 bankruptcy and were restructured by banks. As explained below, this is only the tip of the iceberg of bank control since banks have become increasingly assertive in American corporate governance in the pre-bankruptcy stage.

The point is clear. Directors and managers in the majority of large public companies are increasingly less concerned by “the guillotine” of shareholder control that “catalyzes” the American model. The “limited de jure shareholder voice” has returned and the “de facto” form of shareholder control has increasingly been lost.<sup>139</sup> For well over a decade, a majority of American firms have become insulated from hostile takeovers, which has made the primary mechanism of shareholder control increasingly irrelevant.<sup>140</sup> As explained in the previous section, the assumption is that none of this change has occurred—that the American model has remained static.<sup>141</sup> It would be difficult to construct a less accurate picture of the American model or hostile takeovers in the 1990s.

It is interesting to note that on the occasions when the convergence debate actually acknowledges the decline of hostile takeovers, it does so in a manner that diminishes the importance of the decline and keeps the picture of a static American model intact. A vivid example is provided by Hansmann and Kraakman as they note that, although under current Delaware law incumbent boards have authority to resist hostile offers, “they remain vulnerable to bids that are tied to proxy fights at shareholder meetings.”<sup>142</sup> As explicitly shown above, this is simply no longer the case for the majority of large American companies who have adopted staggered boards. Similarly, Professor Roe notes in passing, after explaining the integral nature of hostile takeovers in America during the 1980s, that

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research, Professor Anabtawi notes, “[n]ot surprisingly, therefore, one recent study of takeover defenses found that during the second half of the 1990s only about 1 percent of publicly traded companies received a hostile bid, and most of those companies remained independent or were acquired by a friendly bidder.” Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 568 (2006).

<sup>139</sup> Bebchuk & Cohen, *supra* note 9, at 410; Bebchuk et al., *supra* note 9, at 895.

<sup>140</sup> As Bainbridge notes, “[t]akeover defenses reasserted the target board’s primacy, by extending the board’s gatekeeping function to the nonstatutory acquisition setting.” Bainbridge, *supra* note 133, at 792.

<sup>141</sup> Shishido is a notable exception in the convergence debate, in that he finds that “[i]t is no longer true that American corporate governance symbolizes capital market centered monitoring. Because of the development of poison pills and anti-hostile takeover statutes, real hostile takeovers are now rather rare.” Shishido, *supra* note 9, at 220.

<sup>142</sup> Hansmann & Kraakman, *supra* note 2, at 458.



“despite the rise of the poison pill” hostile takeovers still “are an engine of shareholder wealth maximization.”<sup>143</sup> Again, the failure to mention staggered boards speaks volumes. That the convergence debate continues to ignore the fundamental shift in shareholder primacy due to the dramatic decline in the influence of hostile takeovers is obvious. The reasons for this curious denial are less so.

C. *The Decline in Dispersed Shareholding Has Altered the American Model*

Recently, the convergence debate has become fixated on explaining why all other countries (except England) have failed to adopt dispersed shareholding.<sup>144</sup> The explanations rely on the assumption that dispersed shareholding is the end in the evolution of corporate governance and that America, by reaching that end, has finished evolving.<sup>145</sup> This is an error.

The dispersed shareholding endpoint assumption creates two testable hypotheses. If the assumption is true, one would expect to find that: (1) American corporate governance has not “regressed” back towards a more concentrated shareholding structure, and (2) America’s largest and most successful public companies are indeed dispersedly held. Both of these hypotheses are *unsupported* by the empirical evidence. In addition, a recent article by Professor Gilson demonstrates, based on current empirical findings, that dispersed shareholding is not necessarily any more efficient than concentrated shareholding. This presents a further challenge to the endpoint assumption.<sup>146</sup>

Beginning in the 1970s and continuing through the 1990s, America’s shareholding landscape substantially changed to a more concentrated shareholding system. In the 1970s, dispersed individual shareholders dominated the market by holding 70 percent of available stocks.<sup>147</sup> The percentage of individual shareholders consistently dropped throughout the 1980s and 1990s, so much so that by 1994 only 48 percent of stocks were held by individuals.<sup>148</sup>

During the same period, large institutional investors purchased blocks of stock that were formerly owned by dispersed individual

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<sup>143</sup> Roe, *Shareholder Wealth*, *supra* note 30, at 2074.

<sup>144</sup> Gilson, *Controlling Shareholders*, *supra* note 1, at 1642-43.

<sup>145</sup> *Id.* at 1647.

<sup>146</sup> *Id.* at 1651-1653.

<sup>147</sup> Holmstrom & Kaplan, *supra* note 10, at 14.

<sup>148</sup> *Id.*

shareholders.<sup>149</sup> From 1980 to 1996, the percentage of stocks owned by large institutional investors skyrocketed from less than 30 percent to more than 50 percent of the total market.<sup>150</sup> These statistics paint a picture of a dramatic change towards concentrated block shareholding by large institutional investors and away from dispersed shareholding by small individual investors.<sup>151</sup> From the perspective of the dispersed shareholding endpoint assumption, this thirty-year trend of “regression” towards concentrated shareholding presents a problem.

Indeed, faced with these facts, it is surprising that the endpoint assumption of dispersed shareholding is so pervasive. However, two claims have been made to make the dramatic increase in the concentration of shareholding by institutional investors fit the assumption of a static American model: (1) concentrated shareholding in institutional investors strengthens the American model by reasserting shareholder control, and (2) institutional investors typically own non-controlling blocks (typically less than 10 percent in each company) so they do not assert the same control as larger controlling block shareholders in other systems. Both of these claims are incorrect.

First, there is little evidence that institutional investors increase shareholder control. In fact, the evidence suggests the opposite: institutional investors, like any other block shareholder, have their own interests in mind.<sup>152</sup> Institutional investors are in the business of making money for institutional investors, which does not always coincide with acting in the best interest of shareholders. Actively monitoring management and engaging in shareholder activism costs money, takes time and increases the risks of becoming embroiled in litigation, and

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<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> Bhagat, Blair and Black noted in their analysis of shareholding trends over a sample period from 1983–1993 that there was a “significant secular increase in large-block shareholding . . . with sharp percentage increases in these holdings by mutual funds, partnerships, investment advisors, and employee benefit plans.” Sanjai Bhagat et al., *Relational Investing and Firm Performance*, 27 J. FIN. RES. 1, 2 (2004). As Black puts it in his 1990 article, “the model of public companies as owned by thousands of anonymous shareholders simply isn’t true. There are a limited number of large shareholders, and they know each other.” Black, *Shareholder Passivity*, *supra* note 110, at 574. Shishido notes, “[t]he concentration of share ownership is converging between the United States and Japan. Although dispersed share ownership used to be a typical characteristic of American corporate governance, institutionalization of share ownership has been accelerated since 1980s (Coffee 1991) and now, more than 50% of publicly held stock is owned by institutional investors in the United States.” Shishido, *supra* note 14, at 27.

<sup>152</sup> Bainbridge, *supra* note 1, at 50-53, 57-59.

damaging business relationships. Indeed, self-interest explains why institutional investors devote little time, money, or effort to monitoring management and even “typically disclaim the ability or desire to decide company-specific policy questions.”<sup>153</sup> It also explains why they rarely engage in the most obvious forms of exerting shareholder control such as conducting proxy solicitations or putting forward shareholder proposals.<sup>154</sup>

As Bebchuk explains:

Among other things, money managers would not wish to devote management time to a contest over one firm’s governance because they focus on trading and portfolio management, and they would wish to avoid any risk of litigation or company retaliation.<sup>155</sup>

The observation that institutional investors do little to assert shareholders’ interests is confirmed by empirical studies that find “no strong evidence of a correlation between firm performance and percentage of shares owned by institutional investors.”<sup>156</sup>

It is not surprising that institutional investors are self-interested, just like any other block shareholder. The fact that institutional investors act in their own self-interest and do not increase shareholder control makes the dramatic increase in the concentration of shares, which are held by institutional investors, a significant development in American corporate governance. Indeed, it demonstrates a movement away from dispersed shareholding—which is not contemplated by the endpoint assumption. The argument that the increase in concentrated shareholding is insignificant because it has merely reinforced the American shareholder primacy model does not hold.

Second, it is incorrect to assert that the concentration of shares in institutional investors does not alter the dispersed shareholding model because institutional investors typically own non-controlling blocks of shares (generally less than 10 percent).<sup>157</sup> If this were the case, Japan, where less than 10 percent of Japanese companies have a shareholder with more than a 20 percent stake,<sup>158</sup> would not be classified as a concentrated

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<sup>153</sup> *Id.* at 50.

<sup>154</sup> *Id.*

<sup>155</sup> Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 *BUS. LAW.* 43, 52 (2003).

<sup>156</sup> Black, *Shareholder Activism*, *supra* note 110, at 462.

<sup>157</sup> Bainbridge, *supra* note 1, at 50.

<sup>158</sup> Rafael La Porta et al., *Corporate Ownership Around the World*, 54 *J. FIN.* 471, 492 (1999); *see also* Stijn Claessens, *The Separation of Ownership and Control in*

shareholding system—but it is.<sup>159</sup> Japan is classified as a concentrated shareholding system because during the 1980s and 1990s almost 45 percent of its shares were held by stable shareholders.<sup>160</sup> The constituency of Japanese stable shareholders consists of non-controlling block shareholders, typically holding less than 5 percent, who are said to have a common interest (i.e., supporting management) that is not necessarily in line with shareholders' interests.<sup>161</sup> This is precisely what has happened in America with over 50 percent of shares held by non-controlling block institutional investors who work in their own common self-interest and not in the interest of shareholders. Consequently, the concentration of shares is significant.<sup>162</sup>

This is not to say that American institutional investors work in the same way as Japanese stable shareholders. They do not.<sup>163</sup> The point is that in both systems a considerable portion of shares is held in non-

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*East Asian Corporations*, 58 J. FIN. ECON. 81, 81 (2000) (overview of Japan's shareholding structure).

<sup>159</sup> Gilson, *Controlling Shareholders*, *supra* note 1, at 1670.

<sup>160</sup> Ronald J. Gilson, *Reflections In A Distant Mirror: Japanese Corporate Governance Through American Eyes*, COLUM. BUS. L. REV. 203, 208-09 (1998); *see also*, FUMIO KUROKI, NLI RESEARCH, THE RELATIONSHIP OF COMPANIES AND BANKS AS CROSS-SHAREHOLDINGS UNWIND - WISCAL 2002 CROSS-SHAREHOLDING Survey 6, fig.3 (2003), available at <http://www.nli-research.co.jp/eng/resea/econo/eco031118.pdf>. (describing the rate of stable shareholding in Japan); Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3, 25 (1996) (providing a concise description of the effect on Japan's stable shareholding structure on Japanese corporate governance).

<sup>161</sup> Milhaupt, *supra* note 25, at 2185; La Porta et al., *supra* note 158, at 492, 496-97; Claessens, *supra* note 158, at 103-04, 106; Gilson, *supra* note 160, at 208-09; Milhaupt, *supra* note 160, at 25, 31; Aoki, *supra* note 12, at 14. Legal restrictions have long existed on Japanese banks that impose limits on the percentage of shares that they can hold in a single company. During the high growth era, Japanese banks were prohibited from holding more than 10 percent of a company. The passage of the Revised Anti-Monopoly Act of 1977 gave banks ten years to bring their holdings in a single company down to 5 percent. TAKEO HOSHI & ANIL KASHYAP, CORPORATE FINANCING AND GOVERNANCE IN JAPAN: THE ROAD TO THE FUTURE 124-125 (2001).

<sup>162</sup> It is suggested that the larger a firm is the smaller percentage of equity that is needed to control it. In this sense, the large size of U.S. companies makes a small percentage sufficient to provide control. La Porta et al., *supra* note 158, at 497. Indeed, there is evidence of institutional investors using such influence to extract substantial private benefits in America around the turn of the century and in present-day Russia. Bainbridge, *supra* note 1, at 58.

<sup>163</sup> It has historically been in the interest of Japanese stable shareholders to support incumbent management actively, while empirical evidence suggests that American institutional investors have been largely passive.

controlling blocks by institutions that do not necessarily have the same interests as shareholders. Perhaps the only justification for differentiating American institutional investors from Japanese stable shareholders is that historically it has been in the best interest of the latter to support management by blocking hostile takeovers.<sup>164</sup> If, however, the sole criterion for classifying the American model as a dispersed shareholding system is its efficient hostile takeovers regime, then we again confront the rise of the poison pill and staggered board defense. Either way, the evidence points to a significant evolution away from the American model since the late 1980s.

Even putting institutional investors aside, the current state of shareholding in America's largest companies is anything but uniformly dispersed. In fact, as noted in a recent article by Professor Gilson, recently some of America's most prominent and innovative firms such as Google and DreamWorks "went public with 'Swedish' capital structures—the founders retained stock with many times the voting power of the class of common stock sold to the public."<sup>165</sup> In addition, he notes that, "recent research indicates that in 1998 there were 255 U.S. publicly traded companies with dual class stock and that 34% of the S&P 500 companies have founder family equity ownership with average holdings of 18%."<sup>166</sup> The view that dispersed shareholding is the end in the evolution of corporate governance seems to have been lost on these highly successful American firms.

Professor Gilson's recent article provides yet another challenge to the dispersed endpoint assumption. Using recent empirical evidence, Gilson demonstrates that dispersed shareholding systems are not necessarily any more efficient than concentrated shareholding systems.<sup>167</sup> This makes the endpoint assumption untenable. If, as Gilson suggests, concentrated shareholding can be equally efficient as dispersed shareholding, if not more so, then it makes sense that America will fluctuate between dispersed and concentrated shareholding across industries and over time. Indeed, as this section demonstrates, such a shift occurred in the 1980s and 1990s.

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<sup>164</sup> Gilson, *supra* note 160, at 208-09.

<sup>165</sup> Gilson, *Controlling Shareholders*, *supra* note 1, at 1660.

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*

*D. The Importance of Bank Monitoring Turns the American Model on Its Head*

It is clear that the fundamental features of the American model have changed. The fact that shareholder primacy has been significantly eroded and dispersed shareholding has fallen proves that the endpoint assumption is false. In this sense, the analysis could stop here. However, as history would have it, the American model has evolved to become the one thing that by definition it is *not*: a governance system in which banks are the principal mechanism for monitoring and replacing underperforming management.<sup>168</sup> History could not have provided better evidence that the American model has continued evolving.

The convergence literature definitively disavows any significant involvement of banks in the American model. Professor Gilson, in his article on functional/formal convergence, describes the accepted view of the American model as having a “large number of comparatively small banks that for practical purposes play *no role* in corporate governance.”<sup>169</sup> The literature is replete with examples distinguishing the American model from the Japanese and German models on the basis that the former is devoid of bank monitoring.<sup>170</sup> Indeed, American evolutionists suggest that the world has learned from America’s absence of bank monitoring, as a “broad normative consensus” has emerged around the world that banks should not be involved in corporate governance.<sup>171</sup>

The absence of bank influence is so ingrained in the American model that a well-known path dependence story has developed to explain this phenomenon.<sup>172</sup> As the story goes, America’s distrust for the concentration of financial power and idiosyncratic regulations hobbled the development of American banks. In the wake of the 1929 stock market crash, skepticism of large financial intermediaries led to the Glass-Steagall Act, which forced the separation of commercial and investment banks.<sup>173</sup> This, combined with a federal regulatory system that prohibited banks from expanding beyond state borders, created banks that “were too small

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<sup>168</sup> Baird & Rasmussen, *supra* note 8, at 1212.

<sup>169</sup> Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 342.

<sup>170</sup> *Id.*

<sup>171</sup> Hansmann & Kraakman, *supra* note 2, at 441-42. Similarly, Coffee states in his 1999 article, “the tide of opinion has lately turned against the presumed superiority of banks as monitors.” John C. Coffee, Jr., *The Future As History: The Prospects For Global Convergence In Corporate Governance and Its Implications*, 93 NW. U.L. REV. 641, 643 (1999).

<sup>172</sup> Coffee, *supra* note 171, at 660.

<sup>173</sup> *Id.*

and too legally constrained to serve as effective monitors of U.S. industrial corporations.”<sup>174</sup>

From a path dependence perspective, the historical constraints on banks led to the development of America’s functionally optimal market based monitoring system—ostensibly driven by hostile takeovers. Having attained a functionally optimal system, path dependence theory suggests that the system will not formally change. Its formal evolution is over. The prospect of developing a bank monitoring system is not even considered. As previously mentioned, formal change is considered a last resort in path dependence theory because it requires costly change to complimentary institutions.<sup>175</sup> The success of the American economy over the last two decades does not suggest a situation of last resort.<sup>176</sup> Indeed, the opposite is assumed: the success of the American economy proves the optimality of the American model and the only question remaining is if others will follow by adopting it. Thus, to suggest that America would develop a system based on bank monitoring is absurd from both the American evolutionist and path dependence perspectives.

Well, then the absurd has become reality. The definitive proof for this comes from a groundbreaking 2006 article by two leading American scholars, Professors Baird and Rasmussen.<sup>177</sup> They conclude that banks, defined as traditional banks and other private lenders, have become: (1) “the principal mechanism” for replacing ineffective management in underperforming firms,<sup>178</sup> (2) the most important mechanism for monitoring companies throughout their entire life (not just post-bankruptcy),<sup>179</sup> and (3) a significantly more important governance mechanism than hostile takeovers.<sup>180</sup> They paint a vivid picture of the critical importance of bank monitoring in American corporate governance and also describe the reasons why the importance of banks has significantly increased over the last several decades.

According to Baird and Rasmussen, contrary to popular wisdom, bank lending plays a critical role in corporate America. The sheer volume of bank loans is enormous. It “now exceed[s] half a trillion dollars per

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<sup>174</sup> *Id.*

<sup>175</sup> Gilson, *Globalizing Corporate Convergence*, *supra* note 1, at 336.

<sup>176</sup> *Id.*

<sup>177</sup> Baird & Rasmussen, *supra* note 8, at 1212.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 1213-1220.

<sup>180</sup> *Id.* at 1223-24, 1236.

year.”<sup>181</sup> The private debt market dwarfs the public debt market with only 17 percent of all outstanding debts being public.<sup>182</sup> Almost all public companies carry debt at some point in their existence and the majority that do rely solely on private debt.<sup>183</sup> In sum, bank lending plays an integral role in financing most American companies.

The influence of banks on corporate governance is rooted in the loan covenants that companies enter into when they borrow from a bank. These loan covenants, “which routinely exceed one hundred pages,” include a litany of requirements that must be fulfilled by the debtor company.<sup>184</sup> These requirements, which Baird and Rasmussen refer to as “trip wires,” are wide ranging and include everything from “minimum cash receipts to delivery of audited financial statements.”<sup>185</sup> Normally, when a company fails to meet one of these trip wires the bank is granted “de facto control rights” over every aspect of the business, including replacing the CEO with someone approved by the bank.<sup>186</sup> Advanced technologies and reforms to the laws governing security interests have allowed banks to precisely track debtors’ cash flow and have made trip wires sensitive to debtors’ real time business performance.<sup>187</sup> In short, banks are granted control rights through loan covenants that allow them to take the reins of corporate governance and replace management when companies underperform.

Even when the debtor does not technically trigger a trip wire, the bank’s influence looms large. Management and directors must take account of trip wires in their day-to-day decisions. Also, a bank’s threat to strictly interpret possible future breaches of the trip wires is used to coerce directors to follow their wishes and sometimes involves sacking the CEO and replacing her with a bank-approved restructuring expert.<sup>188</sup> As Baird and Rasmussen note, “[t]oday’s savvy independent board member...pays attention when the business’s banks come calling” even though they “rarely [worry] about the distant threat of a hostile takeover.”<sup>189</sup>

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<sup>181</sup> *Id.* at 1211.

<sup>182</sup> *Id.* at 1244.

<sup>183</sup> *Id.* at 1243-44.

<sup>184</sup> *Id.* at 1216-17.

<sup>185</sup> *Id.* at 1211.

<sup>186</sup> *Id.* at 1211, 1234.

<sup>187</sup> *Id.* at 1228-29.

<sup>188</sup> *Id.* at 1233.

<sup>189</sup> *Id.* at 1236.



Post-Chapter 11, the bank's control over the business is even more authoritative. Debtor-in-possession (DIP) loans "nullify the rights of shareholders" and may give banks such sweeping authority as "to take any appropriate action" to meet the requirements under the DIP agreement.<sup>190</sup> The picture painted is of banks with their "hands on the levers of power," monitoring and influencing American corporate governance.<sup>191</sup> The American model has certainly changed. In fact, it has been turned on its head.

An interesting theme that emerges from Baird and Rasmussen's analysis is how the influence of banks on American corporate governance has consistently grown over the last several decades. They note that several decades ago banks could not have exercised so much control.<sup>192</sup> However, a reform to the law governing security interests has allowed banks to take a secured interest in a debtor's business as a going concern and not just their individual assets.<sup>193</sup> This has expanded the scope of bank control to include how the debtor's business is run (i.e., its corporate governance). In addition, advances in technology have made it possible for banks to monitor debtors' cash flow more effectively.<sup>194</sup> This provides banks with real-time information allowing them to know when a debtor is underperforming and to exert their rights effectively under the loan covenant or to threaten to do so to force governance changes in a timely manner.<sup>195</sup>

Baird and Rasmussen also note that changes in the business environment have increased the influence of banks. Compared to a few generations ago, firms today are much less dependent on firm-specific skills of managers.<sup>196</sup> This has allowed banks to effectively parachute restructuring experts into the company in order to improve performance.<sup>197</sup> Also, today's boards have more sophisticated independent directors who are acutely aware of the influence of banks and of the laws that sometimes make it risky for banks to openly work with a company to resolve its problems (e.g., equitable subordination and the tort of deepening

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<sup>190</sup> *Id.* at 1240.

<sup>191</sup> *Id.* at 1215.

<sup>192</sup> *Id.* at 1228-29.

<sup>193</sup> *Id.*

<sup>194</sup> *Id.* at 1229.

<sup>195</sup> *Id.*

<sup>196</sup> *Id.* at 1233.

<sup>197</sup> *Id.*

insolvency).<sup>198</sup> Baird and Rasmussen suggest that these more sophisticated directors have, in turn, learned to respond to banks' subtle directions and enter into "implicit agreements" with them to replace management with a bank-approved manager when needed.<sup>199</sup>

Finally, Baird and Rasmussen point to the development of the poison pill and staggered board defense as having "drastically reduced the threat of hostile takeovers" so that hostile takeovers rarely concern directors.<sup>200</sup> This has made the monitoring of banks all the more important. Baird and Rasmussen paint a picture of a dramatic evolution that has taken place in the American model over the last several decades. Despite the belief of both American evolutionists and path dependence theorists, the end of the evolution of American corporate governance is nowhere in sight.

*E. The American Model Has Not Been Revived by Recent Reforms*

Academic models die hard, especially those like the American model that have supported a decade of debate. Some may argue that recent reforms have bolstered the American model. They may claim that independent directors have taken the place of hostile takeovers to maintain the model's focus on shareholder primacy. In the same vein, others may argue that the Sarbanes-Oxley Act has reasserted the importance of shareholders in American corporate governance. Still others may suggest that the trend towards concentrated shareholding has finished as institutional investors' share of the stock market has leveled off or, conversely, that the growth in institutional investors reinforces shareholder primacy. The thrust of all of these arguments is that although particular governance mechanisms of the American model may have changed, other mechanisms have emerged to maintain the model's fundamental shareholder primacy and dispersed shareholding characteristics. There is little support for any of these arguments.

There is no question that the independent director has become a rallying cry for corporate governance reformers in America and around the world. Indeed, the independent director is sold as being an effective method for increasing shareholder voice, if not indirectly increasing shareholder control. It is also a fact that over the last two decades America has increased the percentage of independent directors on its

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<sup>198</sup> *Id.* at 1235-36.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at 1244.

boards and tightened the definition for independence.<sup>201</sup> The problem is that, despite a litany of studies, there is no conclusive evidence that independent directors affect either corporate value or performance.<sup>202</sup> Thus, the independent director is no replacement for the significant decline in the effectiveness of hostile takeovers, which has significantly eroded shareholder primacy and control. This must be contrasted with the definitive empirical evidence that the poison pill and staggered board defense has markedly decreased shareholder control.<sup>203</sup>

Sarbanes-Oxley is also sometimes held out to be a pro-shareholder reform. However, as others have noted, even assuming it is effective, Sarbanes-Oxley addresses “fraud, not sloth” and “does nothing to replace managers who are honest but inept.”<sup>204</sup> Thus, it is also not an effective replacement for hostile takeovers.

To suggest that the leveling-off of institutional shareholding illustrates that America may cling to its status as being more dispersed than many other countries misses the point. It does not explain the trend towards concentration in the first place or the current trend of some of America’s most innovative and prestigious companies to choose shareholding structures that concentrate control in the hands of a few.<sup>205</sup> In addition, as explained in detail earlier, institutional investors cannot be viewed as a replacement for hostile takeovers. Institutional investors, like all other block shareholders, act in their own self-interest and not in the interest of shareholders. This is also supported by empirical evidence.<sup>206</sup>

Perhaps the most obvious failure in all of these arguments is that none of them provide an explanation for the rise of banks as monitors. Even if the American model maintained its shareholder primacy and dispersed shareholding, the rise in bank monitoring fundamentally changes the American model. From an evolutionist perspective, there is no rationale for the model to adopt another monitoring mechanism when it is already optimal. From a path dependent perspective, it may be suggested that the American model was functionally failing and that this

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<sup>201</sup> In 1973, inside directors held 38 percent of the seats on American boards; by 2004, the percentage of insiders dropped to 25 percent. ROBERT MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 227, 248 (3d ed. 2004).

<sup>202</sup> “There is no solid evidence of a systematic correlation between having a majority of independent directors and corporate value and performance.” Bebhuk, *supra* note 155, at 75 n.59. See also Puchniak, *supra* note 12, at 66-67.

<sup>203</sup> Bebhuk & Cohen, *supra* note 9.

<sup>204</sup> Baird & Rasmussen, *supra* note 8, at 1224.

<sup>205</sup> Gilson, *Controlling Shareholders*, *supra* note 1, at 1660.

<sup>206</sup> Black, *Shareholder Activism*, *supra* note 110, at 462.

drastic failure forced costly formal reforms as a last resort. Some evidence for this may exist post-Enron and WorldCom, but for such evidence to be valid it would have to be assumed that these spectacular corporate failures marked a larger problem with American corporate governance—which is unproven. In addition, suggesting that America changed its model as a last resort does little to explain the consistent rise of bank monitoring throughout the entire recent era of economic prosperity.

In sum, the argument that the American model has adopted new governance mechanisms to fill the void created by the decline of the old ones is not supported by the evidence. The evidence that the American model has fundamentally changed is too extraordinary to overcome. Indeed, if only one of the three changes examined—concentrated shareholding, loss of shareholder primacy, or bank monitoring—had occurred, the endpoint assumption would be incorrect. That all three have occurred makes the endpoint assumption appear ridiculous.

*F. Adaptation, Not Stagnation: The Reason for America's Success*

The evidence is clear. For the last two decades American corporate governance has continued to evolve. The 1980s was a period of dramatic economic restructuring driven by hostile takeovers and vesting ultimate control in shareholders.<sup>207</sup> The 1990s was a period of sustained growth in which companies built on their restructuring gains.<sup>208</sup> During this period, directors were largely insulated from shareholders, allowing them to use their business judgment to focus on building up their newly competitive companies.<sup>209</sup> Throughout this entire period and into the new millennium, banks increased their role as monitors placing pressure on managers to meet their performance targets.<sup>210</sup> The point that emerges is that American corporate governance continually evolves and constantly readjusts the balance of power between shareholders, directors and banks.

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<sup>207</sup> Holmstrom & Kaplan, *supra* note 19, at 127, 136; Roe, *supra* note 4, at 558.

<sup>208</sup> Holmstrom & Kaplan, *supra* note 19, at 136. The evidence provided in a recent article by Professor Bainbridge suggests that the American corporate governance system in the late 1990s and early 2000s was based on director primacy. Bainbridge also describes why it is efficient to provide directors with discretion. However, as explained above, Bainbridge errs in suggesting that director primacy was the sole system of corporate governance that drove America's recent growth era. Bainbridge, *supra* note 1, at 60-63.

<sup>209</sup> This fits with Bainbridge's analysis of American corporate governance when he published his article in 2002. Bainbridge, *supra* note 1.

<sup>210</sup> Baird & Rasmussen, *supra* note 8.

A snapshot of American corporate governance at any point in time over the last two decades would produce a different “American model” depending on when the picture was taken.

America’s economic success over the last two decades is undeniable. America has kept a firm grip on its status as the sole global economic superpower during this time. Japan appeared to be mounting a challenge to this status in the late 1980s, but did not succeed. Whether China will mount a challenge in the next few decades is speculative. Therefore, if corporate governance does in fact matter to economic performance, what American governance has done over the last two decades matters. There must be a secret to its success. The evidence suggests that the secret is the adaptability of America’s system of corporate governance, not its adherence to a particular model.

To those who have not been immersed in the flawed convergence debate, this conclusion will not be surprising. As we have seen, leading American professors have written numerous articles detailing changes in American corporate governance over the last two decades. This article merely pulls together these established findings and brings them to the convergence debate.

#### IV. THE JAPANESE MAIN BANK MODEL REVISITED

##### A. *The Main Bank Model: A Valuable Perspective on the Convergence Debate*

This analysis would be incomplete without considering the recent history of the Japanese main bank model. Japan has been the world’s second largest economy for more than two decades. In the forty-years after World War II, its economic performance outstripped every country in the world, including the United States.<sup>211</sup> For this reason, in the late 1980s, the Japanese main bank model was viewed by many as the end in the evolution of corporate governance.<sup>212</sup> However, the performance of the Japanese economy in the 1990s and early 2000s was dismal.<sup>213</sup> It consistently underperformed the economies of almost every other developed country. Thus, the Japanese main bank model fell out of favor with all but its most ardent supporters.

However, Japan is now in the midst of its longest postwar period of sustained economic growth (2002–present).<sup>214</sup> Although this is not

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<sup>211</sup> ITO, *supra* note 33, at 3-5.

<sup>212</sup> Hoshi, *supra* note 33; Porter, *supra* note 33.

<sup>213</sup> Hoshi & Kashyap, *supra* note 15, at 3-7.

<sup>214</sup> *Great Slump*, *supra* note 15, at 72-73; *Economic Recovery*, *supra* note 16, at

comparable to the pace of the high-growth era (1951–1973), the consensus is that Japan is once again on the rise.<sup>215</sup> The evolution of American corporate governance towards the Japanese main bank model is also undeniable. Indeed all of the features adopted in the last two decades—decline in shareholder primacy and hostile takeovers, concentration of shareholding and bank monitoring—are hallmarks of the Japanese main bank model. Those unable to free themselves from the shackles of the convergence debate may view these facts as proof of the resurgence of the main bank model. Perhaps it is the endpoint after all. Indeed, there would be no stronger evidence of the main bank model's supremacy than having the two largest economies in the world using it.

This section will demonstrate that, although American corporate governance has undeniably adopted a number of the critical features of the Japanese main bank model, to suggest convergence is misleading. This is because the Japanese main bank model no longer exists in Japan.<sup>216</sup> The Japanese government successfully phased out the no-fail bank policy, which altered the Japanese model in significant ways.<sup>217</sup> Importantly, as the reforms began changing the main bank model, Japan's economic performance began to improve. Indeed, it appears that Japan's stubborn resistance to adapt its main bank model throughout the lost decade (1990–2002) contributed significantly to prolonging its economic malaise.<sup>218</sup>

A point of tangency thus arises between American and Japanese corporate governance over the last two decades: adaptation, not any particular model, is the critical factor for determining corporate governance success. In short, America thrived by adjusting its corporate governance to fit its ever-changing conditions. Japan floundered by clinging to a system unfit for the economic challenges it faced. However,

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<sup>215</sup> As Nottage notes, “[a] second reason for greater interest recently in Japanese corporate governance is that its vast economy—still many times larger than China's, for example—seems finally to be pulling itself out of its ‘lost decade’ (and a half) of economic stagnation. Indeed, the author of ‘Japan: The System that Soured’ . . . now argues that it will stun the world in its economic renaissance, albeit probably not for another decade—following a ‘tumultuous battle’ at the political level.” Luke Nottage, *Nothing New in the (North) East? Interpreting the Rhetoric and Reality of Japanese Corporate Governance 2* (2006) (Sydney Law Sch. Research Paper No. 06/2), available at <http://ssrn.com/abstract=885367>.

<sup>216</sup> See Milhaupt, *supra* note 13 (offering a concise overview of some recent reforms to the Japanese main bank model).

<sup>217</sup> Milhaupt, *supra* note 14; see also Puchniak, *supra* note 14, at 57-59 (explaining how the Japanese main bank system stubbornly resisted change and continued to define Japanese corporate governance throughout the lost decade).

<sup>218</sup> Hoshi & Kashyap, *supra* note 15, at 7-9, 14-15.

Japan's recent adaptations appear to have spurred its new era of economic growth.

B. *The Japanization of American Corporate Governance*

The evolution of American corporate governance over the last two decades has indisputably been towards the Japanese main bank model. Each feature that America has adopted—bank monitoring, collective shareholding, and an ineffective market for corporate control—are defining characteristics of the Japanese main bank model.<sup>219</sup> Indeed, even many of the finer points in the way the Japanese main bank model works, which are believed to be idiosyncratic to Japan, seem to have found their way into American corporate governance.

As the name suggests, the main bank model is centered on bank monitoring.<sup>220</sup> Under the classic Japanese main bank model, Japanese firms borrowed from many banks but had a special relationship with only one, their main bank. Typically, the main banks held major payment settlement accounts and were the largest single lenders and the principal shareholders of the company.<sup>221</sup> This made main banks the central repository of accurate real-time information about corporations' financial health and business ventures.<sup>222</sup> Another key facet to main banks' relationships with their company clients was an implied promise to restructure failing companies in times of financial or managerial crisis rather than forcing them into bankruptcy and liquidating their assets.<sup>223</sup>

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<sup>219</sup> See Aoki, *supra* note 12, at 1-50 (concise overview of the main bank model). It should be noted that two prominent scholars, Professors Miwa and Ramseyer, have argued that the main bank system, which is widely believed to have characterized corporate governance in postwar Japan, is actually a myth that has been created by flawed academic research. YOSHIRO MIWA & J. MARK RAMSEYER, *THE FABLE OF THE KEIRETSU* (U. Chi. Press 2006). *But see* Puchniak, *supra* note 14 (critiquing Miwa and Ramseyer's theory); David Gilo, *The Problem of Bank Rescues: A Comment on Miwa and Ramseyer*, 6 *THEORETICAL INQUIRIES* L. 341, 343 (2005); Milhaupt, *supra* note 35, at 425, 435.

<sup>220</sup> MASAHIKO AOKI, *INFORMATION, CORPORATE GOVERNANCE, AND INSTITUTIONAL DIVERSITY* 60-94 (2000).

<sup>221</sup> Puchniak, *supra* note 12, at 46; Milhaupt, *supra* note 4, at 2087-88; Aoki, *supra* note 12, at 2-15.

<sup>222</sup> Puchniak, *supra* note 12, at 46; Milhaupt, *supra* note 4, at 2087-88; Gilson, *supra* note 160 at 210; Aoki, *supra* note 12, at 14-15.

<sup>223</sup> Puchniak, *supra* note 14, at 20-24; Puchniak, *supra* note 12, at 46; Milhaupt, *supra* note 4, at 2088-89; AOKI, *supra* note 220; Paul Sheard, *Main Banks and the Governance of Financial Distress*, in *THE JAPANESE MAIN BANK SYSTEM*, *supra* note 12, at 210-11. Under the American model, the court-led bankruptcy system and the market for corporate control are seen to play the same role as main bank rescue. In its heyday, main bank monitoring did this more effectively than the American system and was a

This promise to rescue was made feasible for main banks because of the government's implied promise to prevent bank failure which came to be known as the no-fail bank policy.<sup>224</sup>

Prior to the burst of the bubble, the intimate long-term relationship between banks and their company clients was seen to be the zenith of efficient managerial monitoring.<sup>225</sup> Having ready access to a wealth of accurate information about client corporations allowed main banks to evaluate managerial performance effectively.<sup>226</sup> Further, main banks' substantial debt and equity positions with client companies gave them the leverage to act upon their information to influence managerial decisions and, when necessary, to even sack senior management and place members of the bank on the company boards.<sup>227</sup> The effect of monitoring by the main bank gave managers an incentive to pursue long-term goals and invest in human capital.<sup>228</sup> Banks were seen as superior to American market-based monitoring because they did not suffer from the same collective action problems as dispersed shareholders, had an incentive to invest in monitoring management and, unlike hostile takeovers, did not force managers to myopically focus on short-term quarterly profits.<sup>229</sup>

The similarities between the Japanese main bank model and Baird and Rasmussen's description of bank monitoring in present day American corporate governance is uncanny. Baird and Rasmussen note that the norm in America's lending industry is for most large loans to be "arranged by a lead bank" which "hold(s) the largest share of the loan

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factor that contributed to Japan's higher growth. According to main bank theory, the main bank is in the optimal position to rescue because it does not suffer from collective action and information asymmetry problems suffered by creditors, managers, and shareholders, and because it is less costly and has better information than the courts or corporate raiders. *Id.*

<sup>224</sup> Milhaupt, *supra* note 14, at 410-411; *see also* Puchniak, *supra* note 12, at 46; Milhaupt, *supra* note 4, at 2088-89; Aoki, *supra* note 12, at 27-32.

<sup>225</sup> Puchniak, *supra* note 12, at 46; Milhaupt, *supra* note 4, at 2087-89; Shishido, *supra* note 9, at 204; Gilson, *supra* note 160, at 209-12; Milhaupt, *supra* note 160, at 22-25.

<sup>226</sup> Puchniak, *supra* note 12, at 46; Milhaupt, *supra* note 4, at 2087; Milhaupt, *supra* note 160, at 22; Aoki, *supra* note 12, at 14-15.

<sup>227</sup> Puchniak, *supra* note 14, at 22-23; Puchniak, *supra* note 12, at 46; AOKI, *supra* note 220, at 71; Aoki, *supra* note 12, at 25-26; Sheard, *supra* note 223, at 193, 211; Gilson, *supra* note 160, at 210; ITO, *supra* note 33, at 116.

<sup>228</sup> Puchniak, *supra* note 12, at 46; Coffee, *supra* note 171, at 648-49; Gilson, *supra* note 160, at 211-12; Milhaupt, *supra* note 160, at 19-21.

<sup>229</sup> Puchniak, *supra* note 12, at 46; Coffee, *supra* note 171, at 648-49; Milhaupt, *supra* note 160, at 19-21.



and...performs most of the monitoring” of the client company.<sup>230</sup> They assert that banks can efficiently monitor companies because “all of the cash coming into the corporation and leaving it passes through [the bank’s] hands.”<sup>231</sup> With this accurate real-time information, banks can use their influence to effectively intervene, take control of corporate governance and improve the client company’s performance.<sup>232</sup> This arrangement is a spitting image of the relationship between Japanese main banks and their company clients under the main bank model. However, the similarities run even deeper.

Contrary to popular wisdom regarding American lenders, the lead bank does not take the first opportunity to abandon its failing client or force it into bankruptcy. According to Baird and Rasmussen, the lead bank “does not typically sell its interest” or liquidate assets when the client company faces financial difficulties.<sup>233</sup> To the contrary, the lead bank normally has a security interest in the client company as a going concern and therefore it typically is in the bank’s best interest to improve the client company’s performance rather than simply force it into bankruptcy and liquidate its assets.<sup>234</sup> This bias towards improving performance rather than liquidating assets is a defining feature of the Japanese main bank model.<sup>235</sup> This feature has also been viewed as idiosyncratic to Japanese corporate governance and critical in distinguishing the main bank model from American corporate governance.<sup>236</sup>

Baird and Rasmussen further explain that the lead bank relies on its explicit powers under the loan agreement and an implicit agreement with directors to force restructuring changes or even replace the CEO with a bank approved restructuring specialist who “may be compensated by the company, but [whose] interests are aligned with the lenders.”<sup>237</sup> The “implicit agreement” between a main bank and its client company to conduct restructuring is also a central feature in the main bank model.<sup>238</sup>

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<sup>230</sup> Baird & Rasmussen, *supra* note 8, at 1244.

<sup>231</sup> *Id.* at 1229.

<sup>232</sup> *Id.* at 1228-29.

<sup>233</sup> *Id.* at 1244.

<sup>234</sup> *Id.* at 1231.

<sup>235</sup> Aoki, *supra* note 12, at 18; Sheard, *supra* note 223, at 211.

<sup>236</sup> *Id.*

<sup>237</sup> Baird & Rasmussen, *supra* note 8, at 1233-36.

<sup>238</sup> Puchniak, *supra* note 14, at 21-22. *See generally* Aoki, *supra* note 12; AOKI, *supra* note 220, at 60-94; Sheard, *supra* note 223, at 188-230. Again, it should be noted that Miwa and Ramseyer reject that such a promise ever existed in Japanese corporate governance. That such an agreement does not exist in American corporate governance is

That lead banks in America rely on such “implicit agreements” will certainly shock those familiar with the literature on Japanese main banks, since it is hotly debated whether such “implicit agreements” even exist in Japan.<sup>239</sup> In addition, appointing a bank-approved turnaround specialist to improve performance is tantamount to Japanese banks placing a current or former employee on the board of an underperforming client company or sending bank employees to a failing client firm to improve management—yet another hallmark of the Japanese model.<sup>240</sup>

The icing on the cake is that Baird and Rasmussen find that today it is even common in large Chapter 11 cases for senior claims to be converted into equity so the lead bank “will act as a residual owner and will enjoy both the upside as well as the downside” of restructuring an underperforming client company.<sup>241</sup> The fact that Japanese banks owned equity in their underperforming clients was seen as a significant distinguishing aspect of the Japanese model that made banks more amiable to restructuring failing client companies.<sup>242</sup> In sum, it is no exaggeration

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assumed in their analysis. MIWA & RAMSEYER, *supra* note 219, at 64, 147; Yoshiro Miwa & J. Mark Ramseyer, *Deregulation and Market Response in Contemporary Japan: Administrative Guidance, Keiretsu, and Main Banks* 23 (CIRJE Discussion Papers, Paper No. CIRJE-F-267, 2004), available at <http://www.e-u-tokyo.ac.jp/cirje/research/dp/2004/2004cf267.pdf> [hereinafter Miwa & Ramseyer, *Deregulation and Market Response*].

<sup>239</sup> See Puchniak, *supra* note 14, at 30-33 (summarizing the disagreement about the implicit promise); MIWA & RAMSEYER, *supra* note 219, at 78; Miwa & Ramseyer, *supra* note 35, at 407, 417.

<sup>240</sup> AOKI, *supra* note 220, at 71; Aoki, *supra* note 12, at 25-26; Sheard, *supra* note 223, at 193; ITO, *supra* note 33, at 116. Again, Miwa and Ramseyer tell a different story than the dominant view in the literature, claiming that if rescue were to occur, other related firms (not main banks) with some connection to the failing firm (either a partner or firm in the same industry) would come to the rescue. Yoshiro Miwa & J. Mark Ramseyer, *Conflicts of Interest in Japanese Insolvencies: The Problem of Bank Rescues*, 6 THEORETICAL INQ. L. 301, 338 (2005). They suggest that related firms can perform rescue more efficiently than main banks; therefore it does not make sense that banks would save firms by appointing a current or former bank employee(s) to turn around the company. This is because related firms in the same industry as the failing firm “would know better than bankers how to revamp the firm.” *Id.* According to Miwa & Ramseyer, related firms could use valuable industry specific knowledge and skills to more efficiently guide the restructuring process. Banks do not possess such knowledge or skills, and it would be costly, if not impossible, for banks to acquire them. Yet, it appears that even in current American corporate governance banks appointed turnaround specialists with little knowledge of the particular business or industry to restructure underperforming client firms. Baird & Rasmussen, *supra* note 8, at 1233-36.

<sup>241</sup> *Id.* at 1246.

<sup>242</sup> Milhaupt, *supra* note 4, at 2087-88; Gilson, *supra* note 160, at 210; Aoki, *supra* note 12, at 13-14.

to say that if Baird and Rasmussen's description of present-day American bank monitoring was written as a chapter in Aoki and Patrick's often quoted book, describing the Japanese main bank model, it would not be out of place.<sup>243</sup> The evidence clearly suggests that a version of main bank monitoring has arrived in America.

Another fundamental feature of the Japanese main bank model is its stable shareholding system.<sup>244</sup> As explained above, although Japan has almost no controlling shareholders,<sup>245</sup> a large percentage of its shares have traditionally been held by management-friendly stable shareholders.<sup>246</sup> Throughout the late 1980s and early 1990s, stable shareholders held approximately 45 percent of the shares in the market.<sup>247</sup> The constituency of Japanese stable shareholders consists of non-controlling block shareholders (typically holding less than 5 percent of a company's equity). These stable non-controlling block shareholders have a common interest in supporting management, which may conflict with the interests of other shareholders in maximizing shareholder value.<sup>248</sup>

The resemblance of Japanese stable shareholders to American institutional investors is striking. Throughout the 1980s and 1990s, institutional investors increased their share of ownership of all American stocks to approximately 50 percent.<sup>249</sup> The constituency of institutional investors is made up of non-controlling block shareholders (typically holding less than 10 percent of a company's equity). These institutional non-controlling block shareholders have a common interest in making money as institutional investors, which may conflict with the interests of

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<sup>243</sup> See generally THE JAPANESE MAIN BANK SYSTEM, *supra* note 12.

<sup>244</sup> Milhaupt, *supra* note 25, at 2172, 2184-86; KUROKI, *supra* note 160; Gilson, *supra* note 160, at 208-09; Milhaupt, *supra* note 160, at 25.

<sup>245</sup> La Porta, *supra* note 158, at 492; see also Claessens, *supra* note 158 (an overview of Japan's shareholding structure).

<sup>246</sup> Milhaupt, *supra* note 25, at 2184-86; Gilson, *supra* note 160, at 208-09; Aoki, *supra* note 12, at 14.

<sup>247</sup> KUROKI, *supra* note 160, at 6.

<sup>248</sup> Milhaupt, *supra* note 25, at 2185; La Porta, *supra* note 158, at 492, 496-97; Claessens, *supra* note 158, at 103-04, 106; Gilson, *supra* note 160, at 208-09; Milhaupt, *supra* note 160, at 25, 31; Aoki, *supra* note 12, at 14. Legal restrictions have long existed on Japanese banks that impose limits on the percentage of shares that they can hold in a single company. During the high growth era, Japanese banks were prohibited from holding more than 10 percent of a company. The passage of the Revised Anti-Monopoly Act of 1977 gave banks ten years to bring their holdings in a single company down to 5 percent. HOSHI & KASHYAP, *supra* note 161, at 124-125.

<sup>249</sup> Holmstrom & Kaplan, *supra* note 10, at 14.

other shareholders in maximizing shareholder value.<sup>250</sup> Thus, the rise of American institutional shareholders in the 1980s and 1990s created a feature in American corporate governance that is an important aspect of the Japanese main bank model: a large portion of the stock market is held by a constituency which has a common interest that may conflict with the interest of shareholders in maximizing shareholder value.<sup>251</sup>

Another critical feature of the Japanese main bank model is the absence of a market for corporate control.<sup>252</sup> Stable shareholders' strong support for management has traditionally made hostile takeovers a non-factor in Japanese corporate governance.<sup>253</sup> Similarly, with the evolution of the poison pill and staggered board defense, hostile takeovers have become increasingly marginalized in American corporate governance. As a result, Baird and Rasmussen note that American board members "rarely [worry] about the distant threat of a hostile takeover, but pay[] attention when the business's banks come calling."<sup>254</sup>

The evolution of banks playing a significantly more important role than the markets in disciplining management has clearly resulted in the Japanization of American corporate governance. Indeed, it has even been suggested that the poison pill and staggered board defense may induce "management . . . to make efficient investments in long-term projects."<sup>255</sup> Statements like this, which appear to have been cut and pasted from the standard Japanese corporate governance handbook, once again make the claim that the main bank model is the end in the evolution of corporate governance seem plausible.<sup>256</sup>

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<sup>250</sup> Bainbridge, *supra* note 1, at 50-51, 58.

<sup>251</sup> Shishido, *supra* note 14, at 27.

<sup>252</sup> Milhaupt, *supra* note 4, at 2089-90; Shishido, *supra* note 9, at 207; Milhaupt, *supra* note 160, at 25. See generally W. CARL KESTER, JAPANESE TAKEOVERS: THE GLOBAL CONTEST FOR CORPORATE CONTROL (1991).

<sup>253</sup> Milhaupt, *supra* note 4, at 2089-90; Gilson, *supra* note 160, at 208-09.

<sup>254</sup> Baird & Rasmussen, *supra* note 8, at 1236.

<sup>255</sup> Bebchuk & Cohen, *supra* note 9, at 414.

<sup>256</sup> In the early 1990s, Michael Porter credited the Japanese bank centered model with allowing companies to efficiently focus on enhancing long-term growth. He contrasted this with what he saw as the shortsighted approach forced on American managers by fickle myopic markets dominated by hostile takeovers. Porter, *supra* note 33.

C. *The American Model Is Not Converging but Continuing to Evolve*

The evolution of American corporate governance has clearly been towards the Japanese main bank model. However, it would be incorrect to claim that America is on the verge of adopting the main bank model. A detailed review of America's bank monitoring, shareholding structure, and hostile takeovers regime would certainly yield innumerable important differences between the American model and the Japanese main bank model.<sup>257</sup> However, it is unnecessary for the purpose of this analysis to undertake such a detailed examination because America shows no sign of developing one fundamental feature of the Japanese main bank model, lifetime employment.<sup>258</sup> Without lifetime employment, it would be incorrect to claim that America has adopted the main bank model—even if it continues to increase its reliance on bank monitoring and further limits hostile takeovers.<sup>259</sup>

In Japan, lifetime employment exists in most large firms and covers both white-collar and blue-collar employees.<sup>260</sup> The lifetime employment system involves an implicit promise from the employer to the employee of employment until retirement age. Japanese corporations can credibly make this promise because main banks and stable shareholders largely protect companies from hostile takeovers and help them restructure in times of financial crisis.<sup>261</sup> In return, employees give an implicit promise not to abandon the company, which is reinforced by a non-existent external labor market and a top-heavy compensation system based

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<sup>257</sup> For example, although the effect of hostile takeovers in American corporate governance has considerably weakened since the 1980s, there has yet to be a successful hostile takeover of a major Japanese company. Clearly, the threat of a hostile takeover in the United States, even though significantly diminished, is still much greater than it has been at anytime in postwar Japan. Similarly, although American institutional shareholders and Japanese stable shareholders share the broad similarity of holding a significant portion of the shares in the market and not necessarily acting in the interest of shareholders, they have very different objectives.

<sup>258</sup> Puchniak, *supra* note 12, at 47; Milhaupt, *supra* note 4, at 2085, 2092-95; Shishido, *supra* note 9, at 203-04, 207-08, 213.

<sup>259</sup> In a recent paper, Professor Haley argues that the uniqueness of lifetime employment in Japan and its significant effect on Japanese corporate governance has been incorrectly overlooked in the convergence debate. John O. Haley, *Career Employment, Corporate Governance and Japanese Exceptionalism 2* (Wash. U. Faculty Working Papers Series, Working Paper No. 04-04-01, 2004), available at <http://law.wustl.edu/faculty/workingpapers/haley/corporategovernance.pdf>.

<sup>260</sup> Milhaupt, *supra* note 4, at 2092-95; Shishido, *supra* note 9, at 203-04.

<sup>261</sup> Puchniak, *supra* note 12, at 47; Milhaupt, *supra* note 4, at 2092-95; Shishido, *supra* note 9, at 203-04.

on seniority.<sup>262</sup> In addition, lifetime employment results in Japanese boards being large and almost entirely composed of insiders since a seat on the board is the last stage in the promotion for the most skilled lifetime employees.<sup>263</sup>

Lifetime employment is significant in corporate governance because it changes the incentives for directors and senior management.<sup>264</sup> The absence of an external labor market provides the ultimate incentive to avoid making business decisions that may endanger the company's long-term viability and to resist hostile takeovers by all means necessary. This is easily contrasted with the executive labor market in America which is commonly seen as extremely fluid and where senior management often have incentives, such as stock options and golden parachutes, that make them less risk adverse and even supportive of takeovers.<sup>265</sup>

In sum, American corporate governance has not, and will not, adopt the Japanese main bank model. Developments in American corporate governance are best viewed not through the convergence lens, but by taking them for what they are—significant adaptations that have coincided with an undeniable period of strong economic performance. How has America made such adaptations work so efficiently? The focus on convergence and fixed models obscures the answer to this question.

*D. Japan's Successful Adaptation Is Lost in the Convergence Debate*

Definitive proof that the Japanese main bank model is not the end in the evolution of corporate governance (not merely that America has not yet converged on it) would go a long way towards ending the convergence debate. Without the American or Japanese models, convergence theorists have no endpoint. The best way to prove that the Japanese model is not the end in the evolution of corporate governance is obviously to show that the main bank model no longer exists in Japan and that Japan, like America, has evolved. Indeed, if the main bank model were optimal there would be no reason for Japan to abandon it.

At first blush, it appears obvious that the Japanese main bank model has changed. Since the bubble burst, Japan has substantially reformed its corporate law in an effort to end its economic malaise. In fact,

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<sup>262</sup> Milhaupt, *supra* note 4, at 2092-95; Shishido, *supra* note 9, at 203-04.

<sup>263</sup> Puchniak, *supra* note 12, at 47; Milhaupt, *supra* note 4, at 2092-95; Shishido, *supra* note 9, at 203-04.

<sup>264</sup> Shishido, *supra* note 9, at 203-04.

<sup>265</sup> Shishido, *supra* note 9, at 203-04, 207-08, 213-14; Shishido, *supra* note 14, at 5, 27, 31, 34.

the reforms to Japanese corporate law have been so substantial that Milhaupt describes them as a “sea change.”<sup>266</sup> In addition, a number of the reforms have been aimed specifically at breaking down the main bank model and replacing it with a more American-style governance system. These changes include removing barriers to derivative actions, simplifying mergers procedures, permitting employee stock options and allowing companies to adopt American-style boards.<sup>267</sup>

Statistical evidence also suggests that the main bank model should have changed. From 1992 to 2004, the percentage of stocks owned by banks decreased from 16 percent to less than 6 percent suggesting that main banks may have had less influence over client companies and less incentive to rescue them from bankruptcy.<sup>268</sup> From 1990 to 2002, stable shareholding significantly decreased from approximately 45 percent to 25 percent of the stock market suggesting that it should have been easier to conduct a successful hostile takeover.<sup>269</sup> From 1990 to 2000, there was a significant increase in derivative suits suggesting that management may have been under more pressure to avoid actions destructive to shareholder value, such as refusing to sell shares to the highest bidder in a hostile takeover—again confirming the opportunity for hostile takeovers.<sup>270</sup> There has been a movement towards performance-based pay (e.g., stock options and bonuses), suggesting that managers should have been more inclined to act in the best interest of shareholders.<sup>271</sup>

These statistics and the raft of legal reforms all strongly suggest that corporate governance *should have* significantly changed during the lost decade. However, it did not. In fact, during the lost decade, the main bank model remained largely intact and was even strengthened in some

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<sup>266</sup> Milhaupt, *supra* note 13, at 4-5.

<sup>267</sup> *Id.* at 4-11.

<sup>268</sup> Milhaupt, *supra* note 25, at 2184.

<sup>269</sup> KUROKI, *supra* note 160. At the same time, the percentage of stocks owned by foreigners increased from barely 6 percent of the market in 1992 to almost 22 percent in 2004. Milhaupt, *supra* note 25, at 2184.

<sup>270</sup> Milhaupt, *supra* note 13, at 12. Shareholders have made use of the legislative reforms to derivative actions as almost 494 actions were commenced between 1990 and 2000—whereas only twenty were commenced between 1950 and 2000. *Id.*

<sup>271</sup> In 2004, 46 percent of large firms either had already eliminated, or were planning to eliminate, seniority-based pay for managers. In addition, there has been a rise in stock options since they were allowed in the 1990s. Milhaupt, *supra* note 25, at 2187.

respects.<sup>272</sup> Thus, the story of the lost decade is about Japan's strict adherence to a model of corporate governance despite extensive legal reforms and overwhelming economic pressure.<sup>273</sup>

An effective market for corporate control did not develop during the lost decade. Since the bubble burst, a cadre of academics and practitioners have pointed to statistics of declining stable shareholders, changes in business norms, and foreign influence as certain to bring about a vigorous hostile takeovers market.<sup>274</sup> Almost two decades have passed and there has yet to be a single successful hostile takeover of a major Japanese company, let alone a market for corporate control.<sup>275</sup> Indeed, at

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<sup>272</sup> As Milhaupt notes in reference to the legal reforms in the lost decade, "the more things change, the more they remain the same. Or so it seems with Japanese corporate governance." Milhaupt, *supra* note 13, at 3.

<sup>273</sup> Shishido in a recent article, arrives at a similar conclusion: "Recent reforms of Japanese corporate law have, in fact, introduced substantial elements of formal convergence, whereas corporate governance continues to display functional divergence due to differences in the incentive patterns of major corporate stakeholders." Shishido, *supra* note 14, at 2.

<sup>274</sup> Ronald J. Gilson, *The Poison Pill In Japan: The Missing Infrastructure*, 2004 COLUM. BUS. L. REV. 21, 21 (2004). Kester, in his thorough 1991 book on Japanese hostile takeovers, summarizes the view of a prominent US merchant banker at the time as predicting that with the globalization of capital markets, "value-maximizing investors would use takeovers to replace underperforming managers, change corporate policies, and dramatically restructure companies with the aim of increasing equity value." Japan would be part of this market and therefore would adopt a market for corporate control that looked like the hostile M&A market in America during the 1980s. KESTER, *supra* note 252, at 3-4. Even Kester predicts in his 1991 book that, "a newly active market for corporate control in Japan will fill the void left by receding capital market discipline." *Id.* at 239. Over a decade and a half has passed and a market for corporate control has yet to emerge in Japan. More recently, in a 2004 article, Gilson asserts that "[a] number of events *now* suggest that the long wait for hostile transactions in Japan may be approaching its end." Gilson, *supra*, at 22 (emphasis added). This appears optimistic considering Oji's recently failed hostile bid for Hokuetsu. In typical fashion, the Oji's bid failed at the hands of stable shareholders and entrenched Japanese management. It highlighted the continued weakness of Japanese shareholders. *Japanese Paper Giants Practice Origami on Corporate Rule Book*, AUSTRALIAN, Aug. 9, 2006, at 2 [hereinafter *Japanese Paper Giants*]. Prior to the Oji bid failing, in typical fashion the bid was heralded as a milestone in the nation's industrial history where hostile takeovers are unheard of. In the words of one hopeful market player: "[F]inally we are beginning to see real M&A in Japan." *In Japan, Stocks Rise with Merger Hunches*, INT'L HERALD TRIB., Sept. 12, 2006, at 20; *Oji Throws in Towel on TOB*, NIKKEI WEEKLY, Sept. 4, 2006; *Oji's TOB First by Smoke Stack Firm, Heralds New M&A Era*, NIKKEI WEEKLY, July 31, 2006; see also Milhaupt, *supra* note 25, at 2172, 2186; Milhaupt, *supra* note 4, at 2112-14.

<sup>275</sup> "Japan remains the only developed economy not to have had a successful hostile takeover." *Failed Takeover Bid by Oji Seen as Loss for Hokuetsu*, INT'L HERALD TRIB., Sept. 6, 2006, at 17. Oji's hostile bid for Hokuetsu, which occurred in the second



the time of publishing, the two most prominent hostile takeover promoters in recent memory, Takafumi Horie and Yoshiaki Murakami, appear closer to landing in prison on charges related to unscrupulous business practices than successfully taking over a company.<sup>276</sup> In addition, the recent failure of the hostile bid by Oji Paper for Hokuetsu has the fingerprints of the Japanese main bank model on its demise.<sup>277</sup> The bid offered target shareholders a handsome premium and was widely regarded as making good business sense.<sup>278</sup> Predictably, it failed when a stable friendly shareholder rescued incumbent management and shareholders were denied their justified premium.<sup>279</sup> Despite numerous unscrupulous defensive tactics by Hokuetsu and its stable shareholders, which appeared to patently disregard shareholder interests, not a whisper was heard in a Japanese courtroom protesting the result.<sup>280</sup>

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half of 2006, was the first time that a blue-chip Nikkei 225 company had made a bid for another blue-chip Nikkei 225 company. When the bid was announced, it was heralded as a change in Japanese corporate governance—marking the long awaited emergence of a hostile takeovers market. However, this hopeful wish once again did not materialize. The bid failed in typical fashion with friendly shareholders coming to the rescue of Hokuetsu. Shareholders were denied a handsome 35 percent premium. Despite many questionable tactics by Hokuetsu, which would have likely promoted a storm of litigation by shareholders in almost any other developed country, not a single shareholder objected in court. *Under Pressure: Japan's Basic Industries*, ECONOMIST, Sept. 9, 2006 [hereinafter *Under Pressure*]; *Barbarians within the Gate*, ECONOMIST, Aug. 12, 2006 [hereinafter *Barbarians*]; *Japanese Paper Giants*, *supra* note 274, at 21; *Oji/Hokuetsu*, FIN. TIMES, Aug. 30, 2006, at 14. See generally Dan W. Puchniak, *The Efficiency of Friendliness: Japanese Corporate Governance Succeeds Again Without Hostile Takeovers*, 5 BERKELEY BUS. L.J. (forthcoming in fall 2008).

<sup>276</sup> Several commentators have suggested that the prosecution of these two business icons, which were seen as symbols of the rise of shareholder power and hostile takeovers in Japan, may indicate that the old-style of Japanese corporate governance (i.e., entrenched managers, stable shareholders and no market for corporate control) may still have lots of life. *Last Shot Fired in Battle Between Japan Inc., Disgraced Reformers*, U.S. FED. NEWS, June 13, 2006; *Under Pressure*, *supra* note 275.

<sup>277</sup> *Under Pressure*, *supra* note 275; *Barbarians*, *supra* note 275; *Japanese Paper Giants*, *supra* note 274, at 21; *Oji/Hokuetsu*, *supra* note 275, at 14.

<sup>278</sup> *Id.*

<sup>279</sup> *Id.*

<sup>280</sup> *Japanese Paper Giants*, *supra* note 274, at 21. Another recent unsolicited takeover bid was made by Aoki Industries for Futata. It also failed and has been cited as a further example of the failure of hostile takeovers to take hold in Japanese corporate governance. *Futata Picks Konaka over Rival Aoki Bid*, FIN. TIMES, Aug. 21, 2006, at 19.

Lifetime employment has been equally resistant to change.<sup>281</sup> During the lost decade, the lifetime employment system faced enormous pressure as companies consistently racked up losses and increased debt but the system itself remained largely intact.<sup>282</sup> Even those who suggest that lifetime employment has changed merely suggest it now applies to a smaller subset of core employees, which from a corporate governance perspective changes little.<sup>283</sup> After all, it is core employees who make the important governance decisions.

The relationship between main banks and clients also remained strong during the lost decade. Although cross-shareholding declined, companies actually increased their reliance on bank financing.<sup>284</sup> This is striking considering there was a deregulated bond market throughout the 1990s, which purportedly should have caused businesses to increase their reliance on public debt. To the contrary, throughout the 1990s the ratio of bank lending as a portion of total corporate debt dramatically rose so much that by 2000 it represented over 70 percent of corporate debt. This figure is higher than in 1986 when bond issuance was heavily regulated.<sup>285</sup>

The evidence of the rigidity of the main bank model in the face of dramatic legal reform and extreme market pressure is astounding. Indeed, it would be difficult even for the most zealous American evolutionist to argue that Japan significantly moved towards the American model during the lost decade. For path dependent theorists, Japan's rigidity seems like a valuable piece of evidence showing that historical constraints prevented the world's second largest economy from adopting the endpoint American model. However, this analysis is misleading.

There was a significant change in the main bank model during the lost decade. However, the change is lost in the convergence debate. This

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<sup>281</sup> Haley, *supra* note 259, at 3.

<sup>282</sup> *Id.* According to Professor Haley's 2005 article, "Finally, after a decade of much-touted corporate restructuring, no change is apparent in the basic structure of employment for nearly all medium and large private and public organizations in Japan. Entry-level hiring continues to be the norm and centralized personnel offices the prevailing practice. External markets for experienced managers have yet to develop. We may someday speak of these as the years of a Heisei Renewal but I still very much doubt that we will see it as the era of the Heisei Transformation." John O. Haley, *Heisei Renewal or Heisei Transformation: Are Legal Reforms Really Changing Japan?* 4 (Wash. U. Faculty Working Papers Series, Working Paper No. 05-10-02, 2005), available at <http://ssrn.com/abstract=825689>.

<sup>283</sup> Milhaupt, *supra* note 13, at 21.

<sup>284</sup> Yasuhiro Arikawa & Hideaki Miyajima, *Relational Banking in Post Bubble Japan*, in *CORPORATE GOVERNANCE IN JAPAN* 6 (Masahiko Aoki et al. eds., 2006), available at <http://ssrn.com/abstract=818344>.

<sup>285</sup> *Id.*

is because the change did not relate to adopting a characteristic of the American model but rather it was an adaptation of the main bank model itself. In the late 1990s and early 2000s, the rigid main bank model made a significant (and long overdue) adaptation by removing one of its most fundamental characteristics—the government’s no-fail bank policy.<sup>286</sup>

The no-fail policy significantly contributed to both Japan’s impressive postwar economic growth and to its prolonged economic malaise during the lost decade.<sup>287</sup> Perhaps even more important in the context of this analysis is that the government’s reform to the main bank model, phasing out the no-fail bank policy, appears to be a significant factor in the current economic recovery.<sup>288</sup> As observed with American corporate governance, it is adaptation and not any particular model, that is critical to successful corporate governance. That the convergence debate glosses over this critical adaptation in Japanese corporate governance is further evidence of the debate’s futility.

The no-fail bank policy, which existed throughout the postwar era until the end of the lost decade, was an implicit promise by the government not to allow any bank to fail.<sup>289</sup> The no-fail policy shielded banks from market forces and allowed the government to control their activities through the regulatory incentives it provided.<sup>290</sup>

Prior to the bubble, these incentives drove the extremely efficient governance system that came to be known as the main bank model.<sup>291</sup>

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<sup>286</sup> Milhaupt, *supra* note 14 (providing a detailed review of the no-fail policy in postwar Japan until the late 1990s); *see also* Hoshi & Kashyap, *supra* note 14, at 17-19 (analysis of how the no-fail policy continued even into the early 2000s); Puchniak, *supra* note 14, at 42-59; Imai, *supra* note 14.

<sup>287</sup> The no-fail bank policy is a critical feature of the convoy system—which is at the centerpiece of the main bank model. In the high growth era, this policy and the convoy system allowed the Japanese government to shield banks from market forces and use institutional incentives to ensure that banks efficiently rescued financially troubled, but potentially productive, firms. AOKI, *supra* note 220, at 86; Milhaupt, *supra* note 13, at 410-413; Aoki, *supra* note 12, at 26-32; Sheard, *supra* note 223, at 204-10; Kazuo Ueda, *Institutional and Regulatory Frameworks for the Main Bank System, in THE JAPANESE MAIN BANK SYSTEM*, *supra* note 12, at 89. After the bubble burst, this policy drove main banks to systematically lend to inefficient and unproductive zombie firms throughout the lost decade. Puchniak, *supra* note 14, at 42-59.

<sup>288</sup> *See supra* note 15.

<sup>289</sup> As Milhaupt describes it, “no member of the banking industry was allowed to exit (fail), other than through merger with a stronger member.” Milhaupt, *supra* note 14, at 410.

<sup>290</sup> AOKI, *supra* note 220, at 86; Milhaupt, *supra* note 14, at 410-413; Aoki, *supra* note 12, at 26-32; Sheard, *supra* note 223, at 204-10; Ueda, *supra* note 287, at 89.

<sup>291</sup> *Id.*

One of the keys to the model was that the government regulated the market and banking industry to ensure that no bank failed and to create rents that encouraged banks to rescue potentially productive but financially distressed firms.<sup>292</sup> This incentive structure, which drove bank rescue, was efficient because it prevented valuable firm-specific assets from being squandered by premature liquidation and avoided the significant costs of formal bankruptcies (e.g., coordination problems, conflicts of interest, and strategic behavior).<sup>293</sup> The no-fail policy also created market stability, both in the banking industry and in banks' corporate clients, and allowed other important features of the main bank system, such as investment in human capital and a focus on long-term profitability, to prosper.<sup>294</sup>

However, after the bubble burst, the government's no-fail policy produced the opposite effect.<sup>295</sup> The burst of the bubble dramatically impaired the regulatory capital of Japanese banks and saddled them with a mountain of nonperforming loans.<sup>296</sup> Japanese banks were required by the Basel Accord, which came into force shortly after the bubble burst, to maintain a certain level of regulatory capital or be shutdown.<sup>297</sup> This created the perverse incentive for banks to lend to their worst clients in order to make it *appear* as though they had sufficient regulatory capital and that their nonperforming loans were in check.<sup>298</sup>

The systematic lending to underperforming client companies—which came to be known as zombie firms—was carried out by the entire banking industry on the largest possible scale throughout the lost decade.<sup>299</sup> The result was that the creative destruction of unprofitable firms that should have occurred following the burst of the bubble did not occur. Instead, Japanese banks denied new, more productive firms the necessary capital to grow.<sup>300</sup> Ultimately, this was a major reason Japan

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<sup>292</sup> Puchniak, *supra* note 14, at 22-23; AOKI, *supra* note 220, at 87; Masahiko Aoki, *Monitoring Characteristics of the Main Bank System: An Analytical and Developmental View*, in *THE JAPANESE MAIN BANK SYSTEM*, *supra* note 12, at 109, 128-29.

<sup>293</sup> Puchniak, *supra* note 14, at 22-23; Aoki, *supra* note 12, at 18; Sheard, *supra* note 223, at 190-91, 210-11.

<sup>294</sup> Milhaupt, *supra* note 14, at 411.

<sup>295</sup> Puchniak, *supra* note 14.

<sup>296</sup> *Id.* at 43-44.

<sup>297</sup> *Id.*

<sup>298</sup> *Id.* at 44-45.

<sup>299</sup> *Id.* at 34-36.

<sup>300</sup> *Id.*

lost a decade of economic performance instead of experiencing a short-term banking crisis.<sup>301</sup>

At first blush, bank lending to zombie firms does not appear like a viable long-term strategy. Indeed, free market forces should have quickly culled the banks that engaged in zombie lending and their unproductive clients from the market.<sup>302</sup> This is where the no-fail policy loomed large. During the lost decade, the Japanese government used its forbearance no-fail policy to insulate banks from the market forces that should have ended lending to zombie firms.<sup>303</sup> The government built a complex web of incentives (e.g., creating and sanctioning accounting gimmicks, providing capital at below-market interest rates, practising regulatory forbearance, and using taxpayers' money to pay off bad loans) to ensure that banks who supported zombies would not fail.<sup>304</sup> Empirical evidence demonstrates that main banks, as opposed to other banks or to non-bank lenders, were at the heart of this incentive system, as they played the largest role in zombie lending.<sup>305</sup> Rather than driving productive rescue, the main bank system ensured that unproductive firms survived while it denied new, more productive firms the valuable credit they needed to grow.<sup>306</sup>

The incentive for the government to maintain this main bank zombie system was to avoid the political ramifications of allowing large scale bank and business failures.<sup>307</sup> Where the government had used regulatory incentives to propel growth prior to the bubble, in the lost decade it used them to support zombie lending. This prolonged the recession that turned into the lost decade. In essence, zombie lending and the lost decade are the dark side of the forbearance no-fail policy. They represent efficient main bank rescue of the high growth era gone bad.<sup>308</sup>

As the lost decade ground on, the government's direct and indirect use of taxpayers' money to support banks and their zombie client companies turned what had started out as a bank-based Ponzi scheme into a national Ponzi scheme that gambled the future of Japan.<sup>309</sup> The

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<sup>301</sup> *Id.*

<sup>302</sup> *Id.* at 49.

<sup>303</sup> *Id.* at 49-50.

<sup>304</sup> *Id.* at 50-59.

<sup>305</sup> Peek & Rosengren, *supra* note 15, at 1161-62. *See generally* Puchniak, *supra* note 14, at 57-59.

<sup>306</sup> Puchniak, *supra* note 14, at 57-59.

<sup>307</sup> *Id.* at 42.

<sup>308</sup> *Id.* at 58.

<sup>309</sup> *Id.* at 56.

government accumulated deficits unmatched by any other OECD country and the Japanese economy drove deeper into recession.<sup>310</sup> These pressures eventually forced the government to abandon its forbearance no-fail policy and allow market discipline to begin the long overdue process of disposing of the zombies created by the burst of the bubble.

The process of dismantling the no-fail policy started dramatically in the fall of 1997 when the Japanese government allowed Japan's tenth-largest bank and its fourth-largest securities firm to fail.<sup>311</sup> However, somewhat predictably, the process of ridding Japanese corporate governance of the no-fail policy, which had been in place since WWII, proved not to be simple, short, or complete. Although the first piece of legislation was passed in 1996 in an effort to create an effective statutory framework for a credible bank closure policy, forbearance by government inspectors, multiple extensions of the deposit insurance system and massive government bailouts of banks and their zombie clients extended the no-fail policy, at least in practice, into the new millennium.<sup>312</sup>

Although the government continued some of its forbearance policies into the 2000s, allowing the failure of two large financial institutions in 1997 sent a strong message.<sup>313</sup> In addition, the creation of the FSA in 1999 helped to break the cozy relationship between banks and MOF, their former regulator. Post-2000, there is evidence that the FSA regulators were more diligent in enforcing banking regulations and forcing banks to write off nonperforming loans to zombie firms.<sup>314</sup> Thus, by the early 2000s, a more credible bank closure policy was in place and the

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<sup>310</sup> By the end of 2002, Japan's debt to GDP ratio had risen to over 140 percent and its credit rating was downgraded to the same level as Botswana. TETT, *supra* note 34, at xvi-xvii, xxiv. As the decade moved on, evergreening became self-reinforcing. By the end of the lost decade, some experts suggested that if all of the accounting gimmicks and regulatory aids provided by the government were stripped away, almost no actual private capital actually would have remained in the banking system. Without any real capital there is no other option but to evergreen. Shifting risky loan assets to government bonds (the denominator) does nothing to improve the RBC ratio if there is no capital (the numerator). In the dismal market, raising sufficient capital through issuing new equities was also not an option. Hoshi & Kashyap, *supra* note 15, at 16-18.

<sup>311</sup> Milhaupt, *supra* note 14, at 418-19. *See generally* Shishido, *supra* note 14, at 1, 5-6.

<sup>312</sup> *Id.* at 419-24; *see also* Puchniak, *supra* note 14, at 42-56; Imai, *supra* note 14 (providing empirical evidence that in the early 2000s the initial unlimited coverage under the deposit insurance plan and the government's continued forbearance policy contributed to partially shielding banks from market forces).

<sup>313</sup> Milhaupt, *supra* note 14, at 418-19.

<sup>314</sup> Peek & Rosengren, *supra* note 15, at 1165 n.16; *Great Slump*, *supra* note 15, at 72-73; *Dead Firms*, *supra* note 15, at 77-79.

government was enforcing it by strong arming banks to confront their nonperforming zombie loans. This is supported by empirical evidence which demonstrates that in the early 2000s evergreening began to end, nonperforming loans decreased and large-scale creative destruction of inefficient firms finally occurred.<sup>315</sup>

By 2006, the banking industry had substantially recovered as Japan's largest banks had disposed of most of their mountain of nonperforming loans, repaid most of the funds lent to them by the government and began reporting substantial profits.<sup>316</sup> At the present time, Japan is in the midst of its longest sustained period of postwar economic growth.<sup>317</sup> Some are even predicting that Japan may take another run at becoming an economic superpower.<sup>318</sup>

To date, Japan has not substantially adopted any fundamental characteristics of the American model. Rather, it adapted its homegrown main bank model in order to revive its economy. The fact that Japan failed to adapt the main bank model's no-fail policy sooner substantially contributed to the creation of the lost decade. However, main bank monitoring alone cannot be blamed. Indeed, it was extremely efficient prior to the lost decade. The lesson is clear: adaptation, not any particular model or governance mechanism, is the critical feature in successful corporate governance.<sup>319</sup>

## V. CONCLUSION

The point of this article is simple: there is no endpoint corporate governance model. There is no optimally efficient American model. There is no optimally efficient Japanese model. To be effective, corporate

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<sup>315</sup> Bank of Japan, *supra* note 15, at 30; Peek & Rosengren, *supra* note 15, at 1165 n.16; *Great Slump*, *supra* note 15, at 72-73; *Japanese Banks: Open again for Business*, *ECONOMIST*, Jan. 7, 2006 at 35 [hereinafter *Japanese Banks Open*]; *Genesis*, *supra* note 15, at 31; *Dead Firms*, *supra* note 15, at 77-79; *A Survey of International Banking: Rising Again*, *ECONOMIST*, Apr. 17, 2004, at 70; *Japanese Banks: Better, Not Well*, *ECONOMIST*, May 29, 2004, at 37.

<sup>316</sup> *Great Slump*, *supra* note 15, at 72-73; *Japanese Banks*, *supra* note 315, at 35; David Ibison, *MUFG Bests Toyota's Top Profit Performance*, *FIN. TIMES*, Nov. 25, 2005, at 24; David Ibison, *SMFG Reports Jump in Profits*, *FIN. TIMES*, Nov. 23, 2005, at 30; David Ibison, *Restructured Mizuho Raises Full-year Forecast*, *FIN. TIMES*, Nov. 22, 2005, at 34.

<sup>317</sup> *Great Slump*, *supra* note 15, at 72-73; *Japan's Economic Recovery: Depends on Where You Are*, *ECONOMIST*, May 6, 2006, at 9.

<sup>318</sup> Nottage, *supra* note 215, at 2.

<sup>319</sup> This is supported by Kester's general conclusion that "change and successful organizational adaptation, not five hundred years of tradition, have been the cornerstones of the Japanese corporation since the Meiji era." KESTER, *supra* note 252, at 23.

governance must adapt to fit its ever-changing environment. Certain combinations of governance mechanism may work for certain periods of time. Change, however, will inevitably occur. When it does, how well a country's corporate governance system adapts to its changed environment, not how well it adheres to any particular model, will determine its success.

The convergence debate overlooks this point. In fact, it assumes the opposite. For over a decade, the debate has largely been premised on the false assumption that the American model finished evolving and had reached the end in the evolution of corporate governance. Academics built elaborate theories to explain whether the rest of the world would adopt the endpoint American model. The Japanese government based its reforms on the endpoint American model. International organizations conditioned financial aid on recessionary countries adopting the endpoint American model. Ironically, during this time the American model did not exist even in America.

While academics and policy makers sold the American model, America was busy changing it. It used shareholder primacy, driven by hostile takeovers, to carry out much needed restructuring in the 1980s. It insulated directors from hostile takeovers allowing them to use their valuable discretion to build on their newly restructured companies during the 1990s. It increasingly utilized bank monitoring to create another efficient tool to reduce agency costs throughout this era.

Indeed, the American model changed so much during the 1990s that when the decade was over it looked more Japanese than American. But this misses the point, because the Japanese main bank model also no longer exists. The last two decades of Japanese corporate governance provide the other side of the adaptation coin. The main bank model, which had enjoyed a long period of success, faced a dramatic change in environment following the burst of the bubble. Despite extensive corporate law reforms and a mountain of economic pressure, the main bank model stubbornly resisted change through much of the 1990s. Japan paid the price with a lost decade of economic performance. However, all is not lost. Recent adaptations to the main bank model, not the adoption of the American model, have aided Japan's recent recovery. The convergence debate fails to recognize this change because Japan's reform was to its own model, not towards or away from the American model.

This analysis shows that the convergence debate observes little and obscures much. The convergence approach should be abandoned. Little utility exists in measuring the distance between broadly defined governance models that are constantly evolving in unpredictable ways. The future debate should focus on one unanswered question: What allows each country's system of corporate governance to successfully adapt to change? Academics should be pleased with this suggestion. After all, if the story of corporate law is never-ending, we will always have something new to write about.