

**Corporate Governance in Japan and South Korea:
Two Paths of Globalization**

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Abstract

This paper examines the effect of global pressures on local institutions in a comparative study of corporate governance reform in Japan and South Korea. In the literature on business systems and institutional change, globalization often appears as a monolithic force that either overwhelms all in its path through convergence or is rejected. In this paper, we demonstrate that globalization, in the form of the spread of Anglo-American corporate governance to East Asia, resulted in neither convergence nor rejection, but rather, in two different paths of change. We argue that differences in patterns of reform stemmed from the divergent ways in which local actors—the state, shareholder activists, and large corporations—interacted with each other, and with foreign investors, to respond to external pressures. Two key factors defined these interactions: resource dependencies on global capital, and the way in which local actors framed the concept of corporate governance to fit their ideologies and advance their own interests.

Key words: corporate governance, institutional change, comparative business systems

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Introduction

Capitalist economies vary widely around the world (Hall and Soskice, 2001; Hollingsworth, Schmitter, and Streeck, 1994; Streeck 2000; Whitley 1992). Economies diverge in the role of the state in economic management, ownership structures, corporate finance, interorganizational relationships, and styles of managerial decision-making (Guillen, 2001; Hamilton and Biggart, 1988; Fligstein and Freeland, 1995). These differences arise from distinct trajectories of development, different political systems, and differing conceptions of legitimate patterns of interaction between the state and business, and firms and their employees, customers, and suppliers (Biggart and Guillen, 1999; Dobbin, 1994; Roe, 1994).

Diverse forms of capitalism have persisted in the face of economic and technological development, and global trade and competition (Guillen, 2001). Researchers argue that this is because there is no single “best form” to which all systems must converge, and even if there were, it is unlikely that wholesale convergence would occur so easily. A system of capitalism consists of sets of inter-related institutions, and it is difficult to change one without destabilizing the entire system (Aoki, 2001). Powerful actors within business systems are unlikely to agree to changes that will decrease their power (Bebchuk and Roe, 1999). Ongoing economic relationships between buyers and suppliers for example, or between firms and their employees, are embedded in ongoing

social relationships, and are thus difficult to sever (Granovetter, 1985).

While researchers on systems of capitalism have made a compelling case that globalization does not lead to convergence to single global standard, far less research examines and specifies how external pressures do affect business systems. One of the critical tasks for researchers on globalization is to better understand how exogenous global forces—capital, ideas, and labor—interact with the local actors of a business system and the mechanisms that lead, perhaps not to convergence, but nevertheless, to change.

This paper examines local reactions to global pressures in a comparison of corporate governance reform in Japan and South Korea. In the 1990's, both countries embarked on programs of reform in corporate law and business practices, which altered patterns of corporate ownership, structures of boards of directors, and processes by which managers made decisions. Whereas East Asian forms of corporate governance once had been praised as key to the economic development of the region, reforms in Japan and South Korea aimed to replace elements of the existing systems with distinctively Anglo-American practices—-independent boards of directors, enhanced transparency, and attention to “shareholder value.”

While reform programs in both Japan and Korea introduced elements of the Anglo-American system, the process and outcomes of reform diverged. In Korea, corporate governance reform resulted in laws mandating changes in areas such as board independence and

financial structure. An activist state, an aggressive shareholder movement, and influential foreign investors, linked through a shared ideology of minority shareholder rights, promoted reform. In Japan, corporate governance reform led to laws that increased the flexibility of firms to choose their own corporate governance system. The reform program was the result of fragmented efforts by the ministries and politicians. Firms that were highly exposed to international product and capital markets (Milhaupt, 2003) lobbied for greater flexibility in commercial law and adapted their board structures and reporting practices to please foreign investors. Shareholder activism was less apparent, and corporate governance was framed as a set of choices between the “US” and the “Japanese” systems, and between the interests of shareholders versus employees.

We argue that differences in patterns of reform stemmed from the divergent ways in which local actors—the state, shareholder activists, and large corporations—interacted with each other and with foreign investors, to respond to external pressures. We show that two key factors defined these interactions: resource dependencies on global capital, and how local actors framed the concept of corporate governance to fit their ideologies and advance their own interests.

BACKGROUND

Corporate governance is a set of laws, business practices, and ideologies that defines the relationship between a firm and its stakeholders. Corporate governance systems around the world

are based on fundamentally different understandings of the role of a firm in society, and of the proper relationships between employees, shareholders, creditors, buyers, suppliers, managers, and the community. Defined broadly, corporate governance stands at the center of a nation's socio-economic system, and is closely related to systems of finance, employment, and patterns of growth and innovation (Aoki, 2001; Hall and Soskice, 2001).

The Anglo-American model of corporate governance is based on the notion of separation of ownership and control (Berle and Means 1932; Jensen and Meckling 1976). A corporate governance system aligns the interests of owners and managers, and monitors managers for behavior inconsistent with interests of the owners. Mechanisms that achieve these goals of monitoring and incentive alignment include shareholder-value based compensation and evaluation systems, independent boards of directors, and transparent financial reporting systems.

The Anglo-American system of corporate governance diverged from those of South Korea and Japan. The Korean system of corporate governance was highly influenced by Japanese practices imported during the period of Japanese colonization and during the rapid growth years of the postwar period. Both economies featured business groups, though there were important differences in the structure of ownership and control in Korea's *chaebol* and Japan's *keiretsu*. Corporate finance in both countries featured a high reliance on bank debt. While Korean firms had a more antagonistic relationship with labor than Japanese firms, in both cases employees were

considered long-term stakeholders, as downsizing was difficult, if not impossible. In both systems, shareholders tended to be insiders—family members, buyers and suppliers, affiliated firms, and banks—and accounting regulations offered little assurance of transparency to outsiders.

During the 1990's, the Anglo-American system came into direct contact with corporate governance systems of Korea and Japan—and with other systems around the world. Institutional investors from Anglo-American economies expanded their investments outside of their home countries and demanded familiar standards of corporate governance (Useem, 1998). International agencies such as the IMF and World Bank advocated Anglo-American corporate governance. Academic economists and business consultants advocated Anglo-American practices to improve corporate performance and invigorate capital markets (Shleifer and Vishny, 1997; McKinsey).

Trajectories of globalization: The divergent experiences of South Korea and Japan under pressures for reform indicate that business systems do not remain inert in the face of globalization, but rather, shape global influences in country-specific ways. The factors that lead to these different trajectories of globalization remain under-theorized, though some theory and research has begun to fill this gap. In his comparative work on globalization and economic development, Guillen (2001) traced different responses of South Korea, Argentina, and Spain to a complex set of variables, including existing ideologies, relationships between actors, and the structure of the state. Fligstein (2001: 209-213) highlighted the role of governments in mediating

the effect of foreign capital, through the ability to create and regulate financial markets. In his work on regulatory reform in Japan, Korea, and France, Tiberghien (2002) further emphasized the role of the state in mediating the influence of global pressures, arguing that the state actively engaged in reform to facilitate the entrance of foreign capital, and to respond to pressures of foreign investors.

In this paper, we see the state as just one actor, albeit an important one, and highlight the role of other actors—shareholder activists, large corporations, and foreign investors¹—in mediating global influences. Our analysis is based on the fundamental assumption that a system of corporate governance (and, more generally a business system) is composed of a set of interacting actors, which include the state, labor, and capital (Aguilera and Jackson, forthcoming; Hall and Soskice, 2001). It is the interaction between global influences and these local actors that determines the effect of globalization on a local economic system.

In this paper, we also seek to extend theory on the mediation of globalization by local actors by examining the factors that determine how local actors respond to global pressures. We argue that globalization leads to different patterns of resource dependencies across countries and actors—and these patterns of resource dependencies influence the interest of actors in reform. Further, local actors translate global ideas very differently, depending on their interests, and existing ideologies and ways of understanding. These different interpretations can be seen as

¹ In this paper, our focus is on foreign portfolio investors, in particular,

different institutional logics (Friedland and Alford, 1991), which guide the behavior of local actors, and provide shared symbols and identities that define their interactions.

SOUTH KOREA CASE

Chaebols and their founding families

The predominant feature of the Korean system of corporate governance was the chaebol. These diversified, family-owned business groups (Cho, 1990) dominated the economy. In 1996, the top thirty chaebols accounted for 40% of GNP, while the top 5 chaebols accounted for 58% of the total assets of these top thirty (Fair Trade Commission, 1996). Members of founding families of chaebols maintained close control through a web of indirect ownership ties. Family members often held controlling stakes in several *de facto* holding companies that, in turn, held the controlling stake in affiliates, enabling the family to control an affiliate company without holding a single share. In many cases, the founder, or senior member of the founding family, managed operations with a strong, authoritarian hand.

Chaebols were characterized by high levels of unrelated diversification. This originated from the period of military rule, when the government targeted strategic industries for import substitution and export promotion (Amsden, 1997; Kim, 1987) and firms diversified aggressively into these industries to take advantage of preferential credit allocations, tax benefits, and

protection from foreign imports and investments (Steers, Shin, and Ungson, 1989). Chaebols used high levels of bank debt to diversify aggressively into new products and overseas diversification. In 1997, the top 30 chaebols maintained debt to equity ratios of 5 or more. Their top priority was growth over efficiency or profitability, and a belief that the government would always bail them out led them take large risks.

Economic crisis

As the Korean economy opened up in the late 1980s, firms began to face tougher international competition. However, their focus on debt-driven, diversified expansion made chaebols vulnerable to external shocks. In 1997, the average debt-to-equity ratio in the manufacturing sector was 396.3% (MOFE, 2002).² Moreover, as a result of proliferation of strikes and labor unrest, between 1985 and 1995 unit labor costs grew excessively. In 1996, the current account deficit snowballed to 23 billion US dollars. Profit margins, already declining, dropped substantially. The average return on sales of the top 50 chaebol dropped from 2.5% in 1995 to .2% in 1996. Technical bankruptcies of major chaebols including Kia and Hanbo further weakened economic fundamentals.

² Whereas the equivalent figures for Taiwan, Japan, and US were 85.7%, 193.2%, and 153.5% respectively (Taiwan figure is for 1995, Japan and US figures for 1996). In the 1960's and 1970's, Japanese companies had debt to equity ratios of 4 or 5 to 1, but these were reduced as growth slowed and net cash flow increased.

With its extremely high level of foreign debt, Korea could not avoid the economic crisis that ensued when foreign investors lost confidence in many Asian economies in 1997. The negative impact of the crisis was enormous. Korea faced default as foreign exchange reserves fell sharply. In just three months, Korea's sovereign credit rating by S&P plunged from AA- to B+, a speculative grade. Annual GDP growth dropped from above 5% in previous years to -6.7% in 1998 and unemployment increased from 2.6% in 1997 to 6.8% in 1998. During the crisis period, 16 of 30 chaebols (including the third largest Daewoo Group) went bankrupt, were dissolved, or faced major crises. By June 2002, the government had sold, nationalized, or liquidated 631 troubled financial institutions, including 14 banks, a total of 29.8% of all financial institutions that had existed in December 1997. The Korean government also borrowed a total of US\$30.2 billion, including \$19.5 billion from the IMF and \$7 billion from the World Bank.

Corporate governance reform in the aftermath of the crisis

International agencies Both the IMF and the World Bank believed that one of the principal causes of the Korean economic crisis was a malfunctioning corporate governance system. They demanded drastic reforms in corporate structure and business practices, in accordance with a so-called "global standard" (Chung, 2002). In the memorandum outlining the program for economic reform, the IMF and the Korean government agreed to increase the ceiling for foreign

ownership of listed firms from 26% to 55% by the end of 1998, eventually removing even this limit. They also agreed that Korea should liberalize hostile takeovers and inward FDI. The IMF pushed for increased accounting transparency through independent audits, mandated complete disclosure and consolidated financial statements. It urged the government not to intervene in the lending decisions of banks, to cease rescues of troubled corporations, and to pursue policies to reduce corporate debt-to-equity. The IMF further recommended that the government nurture capital markets, reduce the importance of bank loans in corporate financing, and require chaebols to reduce debt guarantees for affiliated companies. The World Bank and the Korean government also signed an agreement outlining key policy actions in upgrading accounting principles and strengthening boards of directors.

The state The IMF and World Bank's assessments of problems in corporate governance were consistent with the position of the Kim Dae-Jung government, which had come to power on a platform that included weakening the grip of founding families on the chaebol. In its program of reform, the Kim Dae-Jung administration went even further than the IMF. For example, although the IMF asked for major reforms in corporate governance, it did not demand the mandatory introduction of independent directors. Rather, the government initiated these requirements, using the IMF recommendations as justification in the face of opposition from large corporations (Lee and Oh, 2001; Tiberghien, 2002).

In early 1998, President-elect Kim Dae-Jung met the chairmen of the five largest chaebols and agreed on the five principles: 1) Enhance transparency of the management through accounting reforms, independent directors, and minority shareholders rights; 2) Clarify debt guarantees among chaebol affiliates, ban new ones and require existing ones to be cleared by March 2000; 3) Improve financial structure by lowering debt-to-equity ratios, and divesting unprofitable, non-core businesses; 4) Focus on core competencies; 5) Increase accountability of the shareholder with the *de facto* controlling stake.

A major priority was to improve the financial structure of corporations (Choi, 2000; Chung, 2002). Firms were required to reduce their debt-to-equity ratio below 200% and by 2000, most chaebols had met the target by issuing new shares and corporate bonds, rather than redeeming their debt. New stock issues jumped from 2.67 trillion won in 1997 to 13.45 trillion won in 1998, then surged to 33.42 trillion won in 1999. Even after targets were met, corporations continued to reduce debt equity ratios through restructuring.

In 1998, the government liberalized the hostile M&A market and introduced policies to protect minority shareholders' rights. In May, the Securities Trading Act was revised to lower the requirements for a class-action lawsuit from a minimum of 1% of outstanding shares to 0.1%. Accounting principles that complied with international standards were introduced in December 1998, and beginning in August 2000, consolidated financial statements became mandatory for the

16 largest business groups. In 2002, penalties for fraudulent public disclosure by listed firms were increased (Chung, 2002; MOFE, 2002).

The state enforced stricter responsibility for corporate failure by filing charges against managers of troubled corporations and financial institutions that had received public funds. The government filed criminal charges against 1310 employees of these institutions, and filed civil suits against 4458 persons, for a total of 1.18 trillion won. The government filed civil suits against 52 former directors of 4 major troubled corporations including Daewoo, and criminal lawsuits against 73 former directors of 27 troubled corporations, and pursued CPAs and accounting firms that had audited troubled firms.

The government also pursued policies to promote inward FDI. In 1998, it liberalized M&A by foreigners and foreign exchange transactions, and enacted the Foreign Direct Investment Facilitation Law. By 2002, almost all sectors, excluding broadcasting, were open to foreign direct investment (MOFE, 2002). Inward FDI increased from US\$3.2 billion in 1996 to \$15.5 billion in 1999 (Chang and Jeon, 2000).

One of the most significant changes was the mandatory introduction of independent directors for large, listed firms. Two years before the crisis, the government had attempted to mandate that listed firms appoint at least 25% independent directors, but gave up in the face of strong opposition from large corporations (Lee and Oh, 2001). In March 1998, the government

introduced a requirement for at least one independent director for every listed firm. The revised Securities Trading Act of October 1999 further mandated that more than 50% of board members (and at least three directors) of listed firms with more than 2 trillion won worth of assets and financial institutions be independent. The new law also required firms to establish an audit committee, two thirds of the members of which were to be independent, including the chairman. From 2000, firms were required to establish a nominating committee, one-half of whose members were to be independent. In 2001, this requirement was expanded to large KOSDAQ-listed firms.

Foreign investors With the liberalization of foreign investment, foreign ownership of shares of listed firms increased from less than 14% in 1997 to about 37% in 2001. By the end of 2002, 32 major corporations had more than 50% foreign ownership. Most foreign shareholders were institutional investors such as mutual funds and hedge funds. Multinational corporations also increased their presence, acquiring local firms and introducing corporate governance and more congruent with their global operations.

Over time, foreign investors raised their voices over major corporate decisions such as diversification into new businesses, policies that favored majority shareholders, and dividend policies. Foreign investors demanded that major corporations with high foreign ownership to appoint foreigners to their boards. According to one survey, of 1342 independent directors for listed companies, about 4.5%, were foreigners (The Korea Economic Daily, October 28, 2002).

Foreign institutional investors also exerted market-based pressure. Sales of shares, or threats of sales, by foreigners forced a number of major corporations to cancel decisions that favored majority shareholders at the expense of foreign and minority shareholders.

Growing shareholder activism through NGOs Non-governmental organizations, particularly, the People's Solidarity for Participatory Democracy (PSPD) played a pivotal role in corporate governance reform. Shareholder activism had been nearly non-existent until 1997, when the PSPD initiated a major campaign on behalf of minority shareholders (Choi, 2000; Lee and Oh, 2001; Chung, 2002). The PSPD's first target was Korea First Bank; subsequently, it expanded its activities to elite chaebol corporations including Samsung Electronics, SK Telecom, and Hyundai Heavy Industries (PSPD, 2002).

The PSPD's basic mode of operation was to raise questions at general shareholders' meetings, resulting in some very long and contentious meetings. PSPD also identified firms that were engaging in illegal activities. In 1999, Hyundai Heavy Industries partly acquiesced to the PSPD by withdrawing their plan to support Hyundai Motors in its acquisitions of Kia Motors and Asia Motors. Ironically, on some occasions, the PSPD's threat of litigation, provided excuses for chaebol companies to refuse requests for help from sister firms (PSPD, 2002). During Hyundai Engineering & Construction's financial crisis in 2001, for example, Hyundai Heavy Industries refused to participate in a bailout due to opposition by the PSPD and minority shareholders.

Of all of the PSPDs activities, perhaps the one with the greatest symbolic significance was a shareholder derivative action on behalf of 61 minority shareholders against former officers of Korea First Bank. The plaintiffs claimed 40 billion won in compensation from the former president and directors of the bank, alleging that they had received bribes in return for providing credit to the failed Hanbo group, resulting in significant losses. A criminal investigation substantiated these allegations, finding that the former president and directors not only received bribes, but instructed staff employees to ignore internal regulations to extend huge loans to Hanbo even when bankruptcy clearly was imminent. In July 1998, the Seoul District Court ruled in favor of the minority shareholders.

The agenda of the PSPD was as much political as financial, and its activism in corporate governance was part of a wide range of activities related to human rights and participatory democracy. In its pronouncements on corporate governance, the PSPD combined a rhetoric of democracy with the language of financial theory. Its leading figure in corporate governance, Professor Jang Hasung of Korea University, held a PhD in finance from Wharton, and was active in academia as well as in the minority shareholder movement. While it had no official ties to foreigners, the PSPD did forge links with foreign investors based on common interests (Milhaupt 2003). In 1998, both the PSPD and Tiger Fund pushed SK Telecom to appoint separate slates of independent directors, and these independent directors formed alliances to oppose SK Telecom's

capital spending plans.³ In 2003, the Center for Good Governance, an NGO founded by PSPD activists, launched a corporate governance fund in conjunction with the International Finance Corporation, Deutsche Bank, and Kookmin Bank.

Large corporations The attitude of large corporations towards reform was mixed. Chaebols tried to resist mandated reforms, especially those regarding independent directors. Corporate chiefs argued that there was an insufficient pool of independent directors with managerial experience and, in response to the government mandates for independent director majorities, many firms simply decreased the size of their boards. Chaebols and the Federation of Korean Industries, their lobbying association, launched media attacks against shareholder activists. Pressure from the government and financial markets, as well as changes in the competitive environment, however, did force chaebols to rethink their corporate governance. Samsung, for example, increased its number of independent directors, and initiated an active shareholder relations program, while the LG Group reconfigured itself into a holding company form.

A number of non-chaebol firms and banks took the lead in governance reform. In 1997, POSCO, the steel manufacturer, voluntarily introduced an independent director system, becoming the first listed company in Korea to do so. Its primary motive was to prevent the government from intervening in its management (POSCO was finally privatized in 2000). Kookmin Bank, Korea's

³ Though its interests in corporate governance converged with those of the Tiger Fund, the non-profit PSPD strongly denied any formal alliance with the for-profit hedge fund.

largest bank, was also acknowledged to be a leader in governance reform. Three-fourths of its board was independent, and two directors were foreigners. In 2003, the Korean Stock Exchange named it as the best governed company in Korea, and the Asia Corporate Governance Association chose it as one of the top ten best-governed companies in Asia. Kookmin Bank's governance practices were perhaps not surprising given its foreign ownership level of 70% (in 2003).

South Korea summary

The Asian Financial Crisis precipitated corporate governance reform in South Korea. The speed and depth of change resulted from a high degree of convergence in interests between the state, foreign agencies, foreign investors, and shareholder activists. IMF and World Bank recommendations were highly consistent with policies of the Kim Dae-Jung government to weaken the chaebol and promote transparency and economic democracy. The state encouraged foreign investment through removing limits on foreign investment, and actively encouraging foreign ownership of failed banks. With their rhetoric of minority shareholder rights and economic democracy, shareholder activists bridged the political objectives of the state with the financial objectives of foreigners. While foreigners, the state, and the shareholder activists may not have consciously coordinated their activities, they all framed corporate governance in similar terms—as encouraging minority shareholder rights and breaking the grip of founder families on the chaebol.

JAPAN CASE

The postwar system of corporate governance

The Japanese system of corporate governance balanced the interests of multiple stakeholders: banks, employees, buyers, suppliers, and managers. The focus was on maintaining long-term relationships between all of these parties, and assuring that all stakeholders shared in good times and sacrificed in bad times.

While individuals held a large percentage of shares, family control was rare in large, publicly traded firms. Shares tended to be owned by banks, buyers and suppliers, and other affiliates. In the late 1980's, corporations held approximately 25% of shares, while banks held about 40% (Tokyo Stock Exchange 2002).⁴ These configurations of firms and financial institutions were often referred to as business groups, or "keiretsu". Because equity stakes tended to overlay ongoing business transactions (Flath, 1993; Lincoln, Gerlach and Takahashi, 1992), for many shareholders, a shareholding stake was not primarily a means to obtain a return on investment (though steady gains, through regular, though small, dividends, and share appreciation were desirable). The accounting system facilitated this: firms reported shareholding stakes at book

⁴ While banks were forbidden by law from holding more than a 5% stake in a firm, a bank, its associated trust bank, insurance company, and other of a banks client firms often collectively owned substantial stakes.

value and shareholders could hold shares in related firms without having to report losses or gains.

Boards of Japanese companies tended to be large and dominated by insiders, with a smattering of directors from ministries, banks, important customers and affiliated firms. By law, the board was required to approve a wide range of decisions in the best interest of the shareholders. In reality, boards were largely symbolic—a rubber stamp for management decisions. Board membership was usually granted to managers with important operating responsibilities, and signified status and prestige. Japanese law also mandated the position of *kansayaku*, or statutory auditor. While officially, shareholders elected *kansayaku* to monitor the board for adherence to the law, in reality, they served at the pleasure of the president, and in many companies, their position was a consolation prize for those unable to attain board membership.

Pressures for change

In the late 1980's and early 1990's, Japanese corporate governance attracted the attention of Japanese and foreign observers, who argued that the Japanese system, with its emphasis on the long-term, was a source of competitive advantage (Porter 1992). Praise for the Japanese system, however, became muted as the Japan plunged into a period of economic crisis and stagnation. While no single crisis ground the economy to a halt as the Asian financial crisis had in Korea, nevertheless, the Japanese economy lurched from crisis to near recovery to crisis again.

In 1990 and 1991, the dual bubbles of the stock market and real estate market burst. A banking crisis, largely due to questionable loans based on inflated real estate and share prices, began to spread. In 1997, Hokkaido Takushoku Bank became the first major bank to fail in the postwar period. Shortly thereafter, Yamaichi Securities, a major securities firm collapsed. The government began to inject public funds into banks, and two banks, LTCB and Nippon Credit Bank were nationalized. The crisis was not limited to the financial sector. By the end of the 1990's, only two auto manufacturers, Toyota and Honda, remained independent and under Japanese control. Major Japanese companies, such as Hitachi and Toshiba, incurred their first losses ever. Unemployment surged from about 2% in 1990 to nearly 6% by 2003.

Waves of scandals accompanied these financial crises. In 1997, several prestigious companies were caught bribing *sokaiya*, or small time gangsters who accepted blackmail to keep shareholders meetings short. Mitsubishi Motors was found to have hidden records on product liability claims. Snow Brand sold spoilt milk and sickened thousands of customers. A rogue trader at Daiwa Bank in New York racked up 1.1 billion dollars in losses in 1995, while in 1996, a rogue trader at Sumitomo Corporation lost 2.6 billion dollars in speculation on the copper market.

Corporate governance reform in the post-bubble era

In the face of these crises and scandals, corporate governance became a major theme that

guided changes in corporate law, finance, financial reporting, and management.

The state As in Korea, the state played an active role in promoting legal and regulatory reform. In contrast to Korea, however, the state's activities were not coordinated from the center, but rather, reflected fragmentary efforts on the part of different ministries and politicians.

Commercial code revision Some of the most important changes in Japan's corporate governance system came through revision of the Commercial Code, the body of law that regulated the relationship between management and shareholders. In 1993, the law was revised to mandate three *kansayaku*, one an outsider, for large companies. In 1997, rules for issuing stock options were liberalized and the ban on holding companies was removed. In 2002, a major reform of the Commercial Code was passed. The new version offered firms a choice between maintaining the board structure under the previous law and adopting a structure similar to that of many US firms, with audit, compensation, and nominating committees that had a majority of independent directors. This reform was not overwhelmingly popular: by the summer of 2003, only 36 listed companies adopted what was called the "US" style committee structure (Nikkei Net Interactive, 2003).

One of the key actors in Commercial Code reform was METI, (the Ministry of Economics, Trade, and Industry, the new name for MITI). During the 1990's, as its role in making industrial policy waned, METI had been trying to carve out a new role as the promoter of deregulation. (Tiberghien, 2002). Reforms spearheaded by METI during this period, including reform of the

Commercial Code, the industrial restructuring law, and the removal of the ban on holding companies, reflected its goal of providing firms with greater flexibility to operate in a global context (Tiberghien, 2002; Milhaupt, 2003).

Accounting reform Revision of accounting regulations began with the announcement in 1996 of the “Big Bang”, a series of moves to open financial markets and put Japan on the map as a leading financial center. The FSA (spun off from the Ministry of Finance in 1998) assumed responsibility for introducing new accounting regulations. By the early 2000s, financial reporting standards for listed firms had converged with international accounting standards. Beginning in 2000, firms were required to report their cross-shareholdings and shares for investment at market levels. Firms were also to report consolidated results for firms in which they had de facto control—making it more difficult for them to hide losses in unconsolidated subsidiaries.

In managing reform, the FSA balanced two objectives: bringing Japanese accounting and auditing standards to a global level and orchestrating a “soft landing” for troubled financial institutions. At times, these two objectives came into conflict. In the late 1990’s, in the midst of new regulations requiring firms to report cross-shareholding at market value, the FSA allowed banks extra time to raise money through selling cross-held shares that had been carried on the books at a low purchase price. Furthermore, in contrast to Korea, where special attention was paid

to corporate governance in banks, banks hardly featured at all in corporate governance reform.⁵

This was particularly interesting since there was wide acknowledgement that problems in corporate governance—low transparency, poor risk management, excessive domination by insiders—all contributed to the banking crisis. Due to wide safety nets and extraordinary forbearance shown by the FSA, banks remained the source of many of the ongoing problems in the Japanese economy in the 1990's and early 2000's.

Politicians Politicians, particularly of the Liberal Democratic Party, were advocates of big business interests. This was especially apparent in the controversy over structure and role of boards of directors. Debate over the role of the *kansayaku* (statutory corporate auditors) and legal liability of corporate directors became heated in the late 1990's. In 1997, the LDP proposed a bill, finally passed in 2001, that included several revisions to the Commercial Code much desired by businesses, including limitation of director liability in shareholder derivative suits and strengthened function of the *kansayaku*.

The 1997 revision of the Commercial Code to allow stock options was a good example of politicians promoting business interests. In response to pressure by businesses, politicians introduced a bill to liberalize stock options directly to the Diet, where it was passed swiftly. This

⁵ This changed somewhat in 2003, when Resona Bank was essentially nationalized, and restructured with an outside CEO and a board dominated by independent directors.

was the first time in the postwar period that politicians had taken a change to the Commercial Code directly to the Diet, rather than going through the usual process of waiting for the bureaucrats, through a Legislative Reform Council, to first draft the law (Milhaupt, 2003).

While politicians supported innovations favored by business, they pushed to repeal accounting regulations that disadvantaged firms. In 2003, politicians and Keidanren pushed to delay implementation of impairment accounting (requiring firms to report value of fixed assets at market value) and to freeze the recently approved requirement to report cross-held shares at market value. Ota Seiichi, the LDP member most active in corporate governance reform, argued that the freeze was necessary to help the Japanese economy, which had gone too far with reform, saying: “Japan has been obsessed with the global standard.” (The Nikkei Weekly, 2003).

Corporations Large firms were key actors in corporate governance reform. In the previous section, we noted that corporations actively lobbied to shape the new regulations. Milhaupt (2003) argued that the period of the 1990’s reflected a “sea change” in law making, with more and more reforms being “pulled” by corporations. Yet, this activity came from only one, relatively small sector of the economy—firms that were highly exposed to global capital and product markets. Many of the changes on the firm level originated with Sony, a company with particularly high levels of foreign ownership and participation in foreign markets. In 1996, Sony introduced a pseudo-stock option (predating the government’s liberalization of stock options in

1997). In 1997, it reduced its board size from 38 to 10, moving directors with operating responsibility off the board, and renaming them *shikko yakuin* or corporate executive officers, and appointing two independent directors.

Of Sony's reforms, the *shikko yakuin* system spread most widely. According to a survey by the Tokyo Stock Exchange (2000), 35.5% of listed firms had introduced the system. Other reforms were less popular. While many companies issued stock options, they had a negligible impact on executive compensation. Independent directors were particularly controversial. Executives argued that outsiders did not understand their business, could not fit in, or simply could not be found. Even at Sony, independent directors remained in the minority.

The corporate governance debate Corporate leaders shaped a heated debate about corporate governance through study groups, reports, and public statements in the media. This debate was framed around the merits of adopting the "US system" of governance versus preserving the "Japanese system." The most vocal proponent of reform was Miyauchi Yoshihiko, CEO of Orix, a financial services firm. Miyauchi was one of the few Japanese CEO's with a US MBA, and a substantial portion of Orix shares were held by foreigners. Other advocates of corporate governance reform were also CEO's of companies with high levels of foreign ownership, including Kobayashi Yotaro of Fuji Xerox and Idei Nobuyuki of Sony. Opponents of corporate governance reform included Okuda Hiroshi, chairman of Toyota and head of Nikkeiren, the

employer's association (and later, Keidanren), and Mitarai Fukio, CEO of Canon. These executives framed corporate governance reform as a tradeoff between shareholders and employees, and argued that adopting the US model of corporate governance would lead firms to abandon strengths of the Japanese system.

Foreigners Foreign ownership of listed shares increased from about 5% in 1991 to nearly 18% in 2003 (Tokyo Stock Exchange). Because foreigners were far more active in trading than most Japanese shareholders, their influence on share price exceeded their weight in the market. Foreigners' share of transactions of shares increased from 30% in 1996 to 39% in 1999, and foreigners were net buyers in each year from 1991 to 1999, except for 1998 (Takahashi, 2000). Foreign institutional investors were vocal, and more likely than Japanese investors to seek meetings with chief executives and ask about corporate governance practices. Their level of activism, however, was limited. Through the 1990's, foreign investors did not actively vote against management, did not submit proposals at shareholder meetings, and did not launch lawsuits. This changed somewhat in after 2000, as foreigners increasingly exercised their voting rights against management.

Foreign corporations and private equity funds also took ownership stakes in Japanese firms. By 2003, foreign companies had controlling stakes in well-known firms such as Nissan and Mazda. Several U.S. private equity firms launched major deals: Ripplewood purchased a majority

interest in Long Term Credit Bank, as well as a failed resort, an audio equipment maker and an auto parts firm. WL Ross purchased a failed bank, selling it at a profit several years later.

The relationship between foreign investors and the government was delicate. Bureaucrats and politicians were disturbed when Shinsei (the new name for LTCB under Ripplewood management) refused to provide rescue funding to the failing retailer Sogo. The FSA later pressured Shinsei to increase lending to small and medium firms of questionable credit-worthiness. On a number of occasions in the late 1990's and early 2000's, the FSA disciplined foreign investment firms for various infractions, and implemented rules that inconvenienced foreigners (such as changing regulations for short-selling of shares with virtually no notice). The media and foreign investors alleged these actions were a form of harassment (Tett 2003).

Shareholder activists

Shareholder suits In 1993, the fee for filing a shareholder derivative suit was reduced from a percentage of damages to 8,200 yen. This reduction in fees triggered a spate of lawsuits—while there had been only 84 suits pending in 1993, by the end of 1999, there were 286 (West, 2001). One of the most dramatic lawsuits was an 83 billion yen decision against the directors of Daiwa Bank in 2000. Many suits were filed by Shareholder Ombudsman, a non-profit organization based in Osaka. While Shareholder Ombudsman was often mentioned in the same

breath as PSPD in Korea, it maintained a much lower profile, and unlike the PSPD, engaged in activism focusing on legal or ethical violations, rather than managerial incompetence or minority shareholder rights (Milhaupt, 2003). Furthermore, it attracted relatively little press from either supporters or detractors (West, 2001).

M&A Consulting In contrast to Shareholder Ombudsman, Murakami Yoshiaki, a shareholder activist running the investment fund M&A Consulting, maintained a high profile. M&A Consulting attracted much attention through two highly publicized, though failed, shareholder actions. In 2000, it initiated a hostile bid for Shoei, which was subsequently defeated. In 2002, after it had purchased an 11.9% stake in Tokyo Style, and demanded it pay investors a 500-yen dividend, buy back its shares, and appoint two independent directors. The proposal was defeated, as friendly banks and affiliated companies came to Tokyo Style's aid (Singer 2002). Murakami was bitterly criticized in the Japanese press for being un-Japanese. Even foreign investors were hesitant to appear closely linked to Murakami.⁶

Japan: Summary

In Japan, as in South Korea, the state played an important role in corporate governance reform. However, government policy focused on promoting flexibility to make Japanese firms

⁶ According to interviews conducted by the authors.

more competitive in global markets. Policy-making reflected a fragmented and diverse set of political actors—with the ministries and politicians advancing their own agendas, and little direction from the Prime Minister and the cabinet. Corporations played a particularly important role, pushing bureaucrats and politicians for reform, and experimenting with new practices, while corporate leaders debated the merits of Japanese versus US style corporate governance. The sharp increase in foreign investors in Japanese financial markets was also an important impetus for reform, but foreigners and the state maintained a wary distance from each other. Japanese who attempted to introduce “US style” practices, like Murakami, were targets of intense criticism.

In Japan, the term “corporate governance” itself was understood in a very different sense from Korea. While actors in corporate governance reform in Korea understood corporate governance as strengthening rights of minority shareholders and weakening the grip of founding families on chaebol, in Japan, “corporate governance” invoked a dilemma of abandoning Japanese ways⁷ in favor of those of foreigners, and of severing long-term relations with stakeholders in favor of short-term shareholders.

⁷ Many of these so-called “Japanese ways,” such as permanent employment were creations of the post-war economy. Yet, Japanese managers we interviewed viewed them as essentially Japanese practices, not simply recent developments.

DISCUSSION

Corporate governance reform in South Korea and Japan diverged in process and outcomes. Korea ended up with a more restrictive legal framework mandating board reform and changes in financial and ownership structure, while Japan ended up with laws that gave firms more flexibility to operate in a global context. In Korea, corporate governance reform featured a strong and centralized state with a contentious relationship with large firms and an active and aggressive shareholder movement. Corporate governance reform was framed around an ideology of weakening the chaebol and promoting minority shareholder rights. In Japan, corporate governance reform was pushed by a set of internationally active firms and government ministries seeking to give Japanese firms more flexibility to operate in global markets and respond to demands of global investors. Corporate governance was framed as a controversial and divisive concept, involving a tradeoff between shareholders and employees, and “Japanese” and “US” systems.

The cases of Korea and Japan demonstrate how similar categories of actors—the state, corporations, shareholder activists, and foreigners—interacted with global pressures in different ways, resulting in different trajectories of globalization. In the following section, we examine two sources of this divergence: different patterns of resource dependencies on global capital, and divergent framing of corporate governance.

Resource dependences: The divergence between Korea’s rapid, state-led introduction of

regulation, and Japan's firm-led, flexibility-enhancing program of reform, can be explained by differences in resource dependence on global capital. According to resource dependence theory, organizations shape their behavior to respond to sources of critical resources (Pfeffer and Salancik, 1978; Thompson, 1967). The degree to which resource dependences shape firm behavior depends on the degree of criticality, substitutability and discretion over that resource.

Korean firms were dependent heavily on debt, supplied by Korean banks, which had borrowed heavily from foreign banks. When foreigners demanded their money back, Korea had to comply. In Japan troubled companies and financial institutions were indebted to Japanese institutions, and the Japanese government stood by with ample funds for bailouts. Thus, while in Korea, foreign funds were critical and non-substitutable, Japan, with its current account balance in international economic transactions and its position as the largest creditor nation in the world, had ample sources of funds, enabling troubled firms to resist external pressures for reform.

Yet, even in Japan, resource dependencies determined patterns of corporate governance reform. In this case, however, corporate governance reform was led not by troubled firms, but by successful ones. Firms that were dependent on global capital lobbied for reform to allow them to respond more flexibly to demands of foreign investors and to operate more effectively in global markets. Firms such as Sony were involved in aggressive programs of mergers and acquisitions overseas, making them more cognizant of their share price, and more exposed to overseas capital

markets.

Framing of corporate governance: Another key determinant of divergence between Korea and Japan was in the framing of corporate governance. In Korea, corporate governance was a question of minority shareholder rights and economic democracy. In Japan, corporate governance was seen as a controversial trade-off between shareholders and employees, and a clash between Japanese and US systems. This divergence in understandings of corporate governance had several implications. In Korea, the framing of corporate governance as promoting minority shareholder rights, weakening the chaebol and advancing economic democracy aligned corporate governance reform with one of the central pillars of government policy. Furthermore, this framing led to a close alignment in interests between the state, shareholder activists, and foreign investors. In Japan, the framing of corporate governance as a tradeoff likely to damage valued institutions was associated with a slower and more piecemeal approach by the state, and to a wariness between the state, shareholder activists and foreign investors.

Research on institutions and institutional change highlights the way in which institutional logics shape the interests of actors and define their behavior (Friedland and Alford, 1991; Haveman and Rao, 1997). Actors define their interests not only based on rational assessments of their resource dependencies and positions, but also, based on socially constructed notions of what is legitimate, appropriate, and possible. A number of studies have demonstrated how divergent

institutional logics result in very different patterns of economic development and institutional change across nations. Dobbin (1994) demonstrated the relationship between ideology and the role of the state in development of railroads in England, the US, and France. Guillen (2001) highlighted the power of ideas in shaping divergent management policies in the US and Europe.

Shared institutional logics also shape the trajectory of institutional change through bridging diverse sets of actors and directing their attention in a common direction. Researchers in social movement theory have noted how common identities and symbols link actors into coalitions of shared interest and action. For example, Davis and Thompson (1994) demonstrated how institutional investors in the U.S. grew to define their interests in terms framed by financial economists, while Ansell (1997) described how the symbol of general strikes united French trade unions in the 19th century. In these cases, linkages between diverse actors emerged through common symbols and ideologies. We observe a similar phenomenon in Korea and Japan, where the concept of corporate governance reform reflected very different institutional logics concerning the purpose of the firm, the problems of economic development, and the role of the state.

Why did Korea and Japan frame corporate governance in such different ways? In Korea, the government actively took advantage of the convergence of its own interests and the ideology of minority shareholder rights. The ease with which government officials and shareholder activists took up the minority shareholder agenda for corporate governance also probably had something to

do with the preponderance in Korean elites of US trained PhD's in finance and economics, who spoke this language of shareholder value fluently, as well as the highly influential Jang Hasung of the PSPD, who was as fluent in the language of financial economics as in the language of democratic reform. Japanese elites, on the other hand, were more likely to be familiar with the works of Aoki Masahiko, who framed Japanese corporate governance in terms of the balance between stakeholders, or Ronald Dore, who praised the communitarian nature of the Japanese company, and its emphasis on employees over shareholders.

There was also a strong difference in popular sentiment in Japan and Korea against big business. The notion that chaebol had too much power, and had to be weakened was popular in Korea, while there was far less sentiment against big business in Japan. This was not to say that there was no anger against big business: the Japanese public was scandalized by corporate misdeeds in the 1990's, especially incidents that involved deception of consumers. And there was general dissatisfaction with banks and financial institutions. Yet, there seemed to be little sense that the system needed to be radically changed. In Japan, corporate executives tended to be seen as supporters of the permanent employment system and providers of stable jobs, unlike in Korea, where chaebol heads were perceived as arrogant and authoritarian, seeking gains for themselves and their families at the expense of shareholders and employees.⁸

⁸ This can be attributed to fact—that Japanese companies were better, more responsible citizens

Conclusion

In literature on business systems and institutional change, globalization often appears as a monolithic force that either overwhelms all in its path through convergence or is rejected. In this paper, we demonstrated that globalization, in the form of the spread of Anglo-American corporate governance to East Asia, resulted in neither convergence nor rejection, but rather, resulted in different trajectories of change. We demonstrated that similar actors—the state, corporations, shareholder activists, and investors—interacted with global pressures in different ways. Both resource dependences on global capital and shared institutional logics of corporate governance determined these interactions. Corporate governance was translated in very different ways, as actors filtered this concept through their existing understandings and ideologies, and redefined it to promote their interests.

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than Korean chaebol, and had committed fewer crimes against shareholders. Or, it can be attributed to better public relations on the part of Japanese companies.

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