

Corporate Governance Reforms, Labor Law Developments, and the Future of Japan's Practice-Dependent Stakeholder Model*

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1. Introduction: Japan's Practice-dependent Stakeholder Model and Challenges it Faces

Law and reality often disagree. The Japanese corporate law presupposes that a corporation is a shareholders' property and the role of management is to maximize the interest of shareholders. Unlike German co-determination law which opens the supervisory board to employee representatives, Japanese law does not give employees or their representatives any status as a constituent of the corporation. Unlike many advanced countries, until the 2003 revision of the Labor Standards Law, Japanese labor legislation did not require any just cause for dismissals and maintained the employment at will doctrine prescribed in the Civil Code. Thus ostensibly Japanese law resembles more the Anglo-Saxon market-oriented model.

In practice, however, it has long been held that employees are the corporation's most important stakeholders. The following comments made by the two leading corporate law professors at the University of Tokyo in the early 1990s illustrated the common perception of Japanese corporate governance at that time:

“There has been a consensus among most corporate law professors that, irrespective of the principles and theories stated in the corporate laws, in practice, larger companies are administered by prioritizing interests of employees including both blue and white collar workers.”¹

“The [German co-determination] system [which attracted attention both in the US and Japan in the 1970s] was not accepted and supported in the United States and Japan. The reasons were, however, quite different.

* This article relies heavily on Araki 2004a and Araki 2004b but focuses on recent changes and reflects updated data. The author is grateful to Ronald Dore who read the previous manuscript and gave invaluable comments.

¹ Egashira 1994, 3.

In the United States, shareholders are the owners of the corporation, and thus the employees' participation in the corporate administration is unacceptable. In Japan, by contrast, it is because employees are already the owners of the corporation."²

A report "Corporate Governance Principles—A Japanese View" published in 1998 by the Corporate Governance Forum of Japan, an advocate of American style corporate governance reforms, confirms the same perception. In its report, the Forum states:

"global competition might be interpreted as a survival race between two corporate systems for higher managerial efficiency: one system seeking a singular value for shareholders, and the other pursuing multiple values including those of employees."³

"What should be done in Japan first is to share the recognition among the people that shareholders are owners of corporation and the purpose of corporation is to pursue interest."⁴

Such employee-centered corporate governance was made possible by the following reasons related to the three parties involved in corporate governance, namely shareholders, management, and employees. First, because of cross-shareholdings and the existence of a stable body of shareholders, the primary concern of shareholders has not been the dividend on the stock but the long-term relationship with the trading partners, and thus they have not actively intervened in corporate governance. Second, directors are mostly promoted from within, and quite a large proportion of board members bear the double functions of director and employee (*jogyoin kenmu torishimariyaku*), and thus management and employees have shared views and interests. Third, long-term or so-called "life-time" employment has made the management deem employees as members of the community rather than mere materials or factors for corporate activities, and voluntarily established forums for labor-management consultation lead the Japanese industrial relations to cooperative ones.⁵

Compared with the German stakeholder model which is sustained and

² Kanda 1992, 28.

³ Corporate Governance Forum of Japan 1998, 8.

⁴ Corporate Governance Forum of Japan 1998, 10.

⁵ As for the details of Japan's traditional corporate governance, see Araki 2004a.

sanctioned by legislation,⁶ the distinctive characteristic of Japan's stakeholder model is its reliance on practices or nonlegal norms. Main pillars that have sustained the Japan's stakeholder system such as the cross-shareholdings and existence of a stable body of shareholders, the internal promotion of board members, long-term employment and labor-management consultation, are simply practices or custom. In this sense, the Japanese corporate governance can be called as the "practice-dependent stakeholder model."⁷

Such practice-dependent model would be vulnerable to the changes surrounding corporate governance. Indeed, significant structural changes are occurring concerning the share ownership, management and monitoring mechanism, and labor and employment relations in Japan. The system of cross-shareholding is dissolving. In particular, in order to write off bad debts and to limit a bank's shareholding so as not to exceed the amount of its own core capital required by the 2001 regulations, major banks have been forced to sell the shares they have held in their trading customers. Drastic corporate law reforms facilitating corporate restructuring have occurred since the late 1990s, and the 2002 revision introduced the American model of a board of directors with great emphasis on external directors. The media repeatedly reports on the collapse of the concept of lifetime employment. Union density continues to decline.

Then, is Japan's traditional employee-centered stakeholder model heading towards the shareholder-centered model? To answer this question, this article first examines the recent changes in share ownership in Japan. Then it reviews the features of conventional management institutions and the drastic legislative changes affecting them. Next it looks at recent changes in long-term employment practice and collective labor relations, and recent labor law developments dealing with such changes. Finally, some evaluation of the current situation and likely evolution of corporate

⁶ The German stakeholder model is legally sanctioned by legislation such as Montan-Mitbestimmungsgesetz vom 21. 5. 1951, Betriebsverfassungsgesetz vom 11. 10. 1952 and Mitbestimmungsgesetz vom 4. 5. 1976 which require co-determination at the level of company (Aufsichtsrat) and by legislation (Betriebsverfassungsgesetz) which gives a works council (Betriebsrat) a co-determination right at the level of establishment.

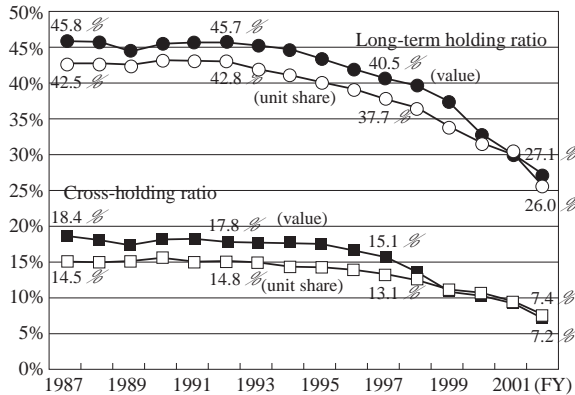
⁷ See Araki 2000a, 259; Araki 2000b, 87; Araki 2004a. Similar observations are made by Dore 2000a, 182, 215 and Milhaupt 2001, 2083.

governance in Japan will be provided.

2. Changes in Share Ownership

The distinctive feature of traditional corporate governance in Japan has been the stable and long-term shareholders and wide-spread cross-shareholding.⁸ However, since the 1990s cross-shareholdings and long-term shareholdings, especially those between banks and their customer corporations, are shrinking in a rapid pace (see Figure 1).⁹ This was caused, in particular, by the continuous decline of stock prices which induced many companies to sell unprofitable stocks and the 2001 Law Restricting Banks' Shareholding calls for banks to reduce shareholdings so as not to exceed the amount of its own capital by the end of September 2006. This Law forced banks to sell their shares in customer corporations and triggered a reciprocal sell-off of bank stocks by the customers.

Figure 1: Cross-Shareholding and Long-term Shareholding Ratios



Source: Kuroki 2003

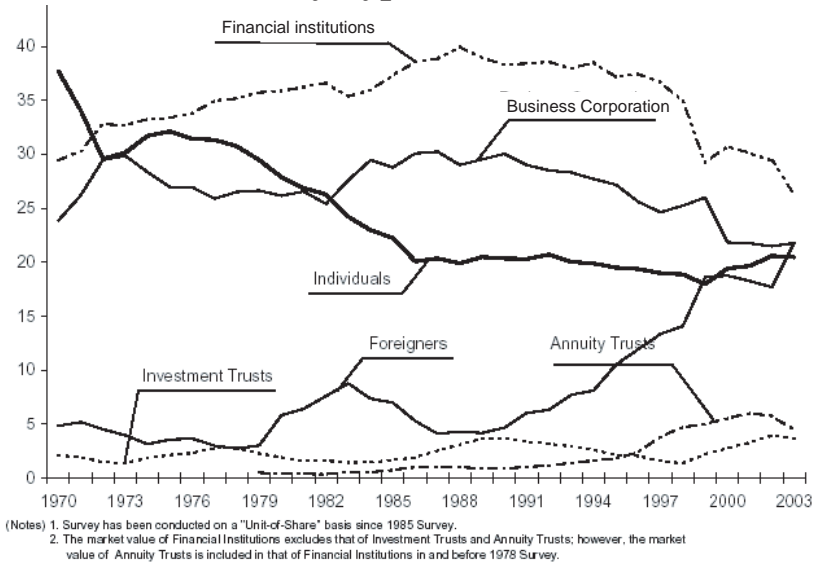
Other important changes in the structure of share ownership are the increase in individual investors and foreign investors (see Figure 2). In accordance with the decline in the ownership of financial institutions and business corporations, individuals emerge as important investors. Unlike traditional Japanese shareholders, foreign investors will require more

⁸ As for the details of the backgrounds of long-term and cross-shareholding in Japan, see Yamakawa 1999, 5; Araki 2004a, 49ff.

⁹ See Kuroki 2003.

shareholder-value-oriented corporate governance than ever. Since their investments tend to concentrate in larger companies,¹⁰ their attitude can

Figure 2 Distribution Percent of Market Value Owned by Types of Shareholders



Source: TSE 2003

have more impact towards corporate governance than their real presence.

3. Corporate Management and Monitoring System

3.1. Traditional Dual Monitoring Model and Introduction of a New Model Utilizing Outside Directors

Until 2002, Japan had a unique dual monitoring system: both the board of directors and auditors monitor corporate management (dual monitoring system, see Figure 3 “Traditional Model”). As for the monitoring by the board of directors, it is said to have an inherent defect in that the monitors (i.e. the directors) themselves engage in corporate administration. Furthermore, since ordinary directors, who often bear dual functions as both junior board members and managerial employees in respective

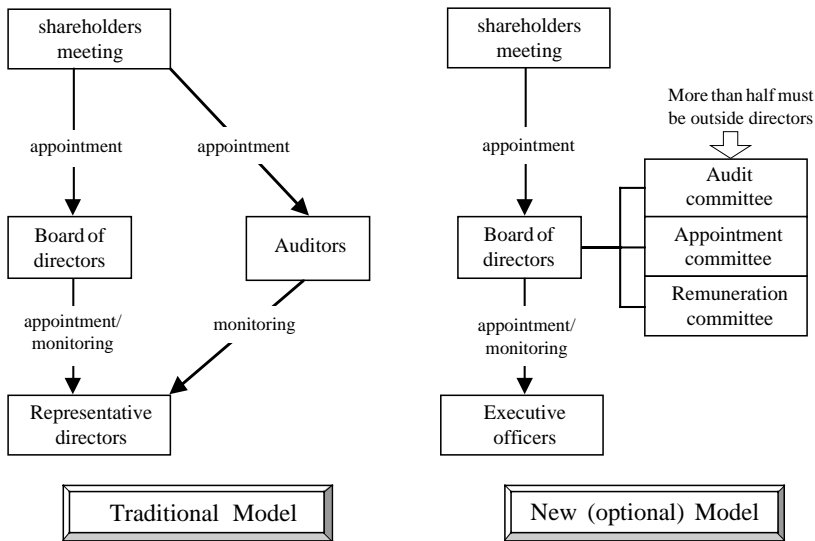
¹⁰ Ministry of Finance, Policy Research Institute 2003, 2-3-1 Overview of shareholders’ structural change.

departments (“*jugyoin kenmu torishimariyaku*” or “directors-with-employee-functions”),¹¹ are in reality subject to the representative directors, it is impractical to expect them to supervise their “boss.”

In the past, therefore, various efforts were made to strengthen the power of auditors and ensure their independence. However, the reforms of the auditor system still fell short of expectations.¹²

In this context, in 1998, the Corporate Governance Forum of Japan proposed a quite radical reform plan: to allow parties to abolish the auditor system by adopting an American-style ‘board of directors’ system utilizing external directors.¹³ The proposal was mostly adopted by the 2002 revision of the Commercial Code and related laws.

Figure 3 : Tow Competing Governance Models



The new model introduced by the 2002 revision is called *iinkai-to setchi gaisha* (company with three committees), as opposed to the traditional governance model now known as *kansa-yaku sonchi gaisha*

¹¹ According to the Top Management Survey (Inagami and RIALS 2000, 87), half of all board members are directors-with-employee-functions. According to another survey (Romu Gyosei Kenkyu-jo 1999, 2), 73.3% of the annual salaries of these dual-function directors is remuneration for the employee function and 26.7% is for the directorship. See Araki 2004a, 55,

¹² See Araki 2004a, 57,

¹³ Corporate Governance Forum of Japan 1998, 43.

(company retaining auditors). To adopt the new model, it is required to establish three committees: an audit committee, an appointment committee and a remuneration committee. There must be more than three directors on these committees, and the majority of them must be outside or non-executive directors. Upon adopting this new governance model, the company's auditors or board of auditors are replaced by the audit committee. Such company must have one or more executive officer(s) (*shikko-yaku*, in effect a CEO). The directors and board of directors concentrate on monitoring and the corporate administration is entrusted to the executive officers (see Figure 3 New (optional) Model).

This American-style, single tier monitoring model with three committees is only available for large companies whose capital is more than five hundred million yen or whose total debt on a balance sheet is more than twenty billion yen and for other companies which are regarded as large companies by the law. For these large companies, it is not compulsory but optional to adopt this model. Therefore, large companies can either maintain the traditional dual monitoring system or, by modifying the articles of incorporation (memorandum of association), adopt the new governance model. In this sense, Japan has entered an era of competition between two different governance models.¹⁴

3.2. Impact of the New Governance Model on Industrial Relations

The new model which introduces outside directors potentially alters the nature of management and affects labor management relations because the current management is internally promoted and this practice has significantly contributed to Japan's cooperative industrial relations and employee-centered corporate governance.

In most larger companies in Japan, management and a majority union conclude a union shop agreement. Under the union shop agreement, all employees are obliged to join the union. This means that current executives were members of the enterprise union in their 20s or 30s when they were rank-and-file white-collar workers.¹⁵ Furthermore, according to the Top

¹⁴ Egashira 2002, 412; Kanda 2004, 163.

¹⁵ Since an enterprise union in Japan organizes workers in the same company irrespective of their jobs, both blue and white collar workers are organized in the same union.

Management Survey, 28.2 percent of top management had previously been not only union members but also leaders of an enterprise union.¹⁶ In a sense, labor-management relations in Japanese enterprises are the relation between present union members and former union members (sometimes between current union leaders and former union leaders). This brings about a consciousness that both labor and management belong to the same community, assists labor and management to find common interests, and leads Japanese management to take a consensual – rather than an adversarial – approach.

In corporations adopting the traditional governance model, nearly half of board members are directors-with-employee-functions. By accepting such dual functionality, it can be said that Japanese corporations have established a channel to voice employees' opinions to corporate management.

However, in the corporation adopting the new governance model, the majority of the committee members must be outside directors representing the interests of shareholders.¹⁷ If widely adopted, the new governance model might have a significant impact on the internal promotion system and labor and employment relations.

So far, however, the number of companies which have adopted the American-style new governance model is rather limited. According to the survey by the Japan Corporate Auditors Association as of September 2004,¹⁸ only 97 listed companies adopted the new governance model although they include such leading corporations as *Sony*, *Toshiba*, *Mitsubishi* and *Hitachi*. In another survey conducted in April 2004 by the Japan Corporate Auditors Association,¹⁹ only 0.2 percent of the surveyed companies plan to adopt the new governance model and 1.4 percent of them are considering the matter. 86 percent of the surveyed companies do not intend to adopt the new model.

¹⁶ Inagami and RIALS 2000, 339.

¹⁷ However, it is not required to make more than half of the board members outside directors. In fact, according to the survey on the companies adopting the new governance model in 2004, the average number of board members is 10.31 and that of outside directors is 4.54. Nihon Kansayaku Kyokai (Japan Corporate Auditors Association) 2004b.

¹⁸ Nihon Kansayaku Kyokai (Japan Corporate Auditors Association) 2004a.

¹⁹ Nihon Kansayaku Kyokai (Japan Corporate Auditors Association) 2004b.

Many Japanese managers prefer the old system on the grounds that it makes for management effectiveness to allow a manager to exert his/her leadership, flexible administration to suit the situation in individual corporations, and effective and expeditious corporate administration.²⁰ The scarcity of suitable candidates for the positions of outside director has further hindered the adoption of the new governance model. As a result, the majority of listed corporations continue to maintain the traditional corporate governance model.

4. Changing Employment Security and Legislative Developments

Employment security has had a high priority in Japanese corporate governance. Employees in Japanese companies have been seen not merely as a factor of production which can be adjusted in accordance with fluctuating economic needs. Instead employees have been treated as important constituents of the corporation.

However, in the last ten years, circumstances surrounding employment have changed dramatically. Traditional lifetime employment is said to be at an end. After the collapse of the bubble economy in the 1990s, the unemployment rate has gradually, and rapidly since 1997, increased and repeatedly reached new records, hitting 5.4 percent in 2002. Reflecting the increased need for corporate restructuring, case law started to relax the economic dismissal regulations. However, several countermeasures to protect employees' interests developed in the last few years. This part reviews the traditional employment system and its recent changes.

4.1. Long-Term Employment Practice and Employment Security

Japan boasted a low unemployment even after the two oil crises. Japan's system of lifetime or long-term employment respecting employment security has been sustained by various social institutions: case law restricting dismissals, state employment maintenance policy, and social norms respecting employment security.

²⁰ Ministry of Finance, Policy Research Institute 2003, Table 3-24.

Although the Japanese labor legislation did not require a just cause for dismissal, courts established a case law rule called the “abuse of the right to dismiss” theory which regards a dismissal without a just cause as an abuse of the right to dismiss making such a dismissal null and void. Therefore, an employer is *de facto* required to demonstrate the existence of a just cause. Courts have interpreted “just cause” very strictly, and tended to deny the validity of the dismissal unless there was serious misconduct by the employee. The courts have considered all of the facts favorable to an employee's case and strictly scrutinized the reasonableness of the dismissal.

After the oil crises in the 1970s, the courts established the so-called four requirements for economic dismissals. Namely, a dismissal for economic reasons lacking the following four requirements should be regarded as an abusive dismissal and thus null and void. The four requirements are: (1) there must be business-based need to resort to reduction of personnel; (2) dismissals must be the last resort to cope with the economic difficulties and thus the employer must take every possible measure to avoid adjustment dismissals.²¹ (3) the selection of those workers to be dismissed must be made on an objective and reasonable basis; and (4) the employer is required to take proper procedures to explain the necessity of the dismissal, its timing, scale and method to the labor union or worker group if no union exists, and consult them regarding dismissals in good faith.

Government employment policy²² has also greatly contributed to employment security. After World War II, Japan's employment policy started with remedial measures such as unemployment benefit programs and job-creation measures to absorb unemployment through public works or government provided unemployment countermeasures. From the mid-1960s, however, in accordance with the spread of the practice of long-term employment, the importance of employment policy moved towards preventive measures such as providing various subsidies to enable

²¹ Before resorting to dismissals, employers are required to take other measures such as reduction in overtime, reduction in regular hiring or mid-term recruitment, implementation of transfers (*haiten*) or ‘farming out’ (*shukko*) with respect to redundant workers, non-renewal of fixed-term contracts or contracts of part-timers, and solicitation of voluntary retirement.

²² See generally Araki 1994, 385; Takanashi 1997, 5; Takanashi 1999, 7; Ohtake 2004, 26.

employers suffering from economic difficulties to retain their workers without resorting to adjustment dismissals. In particular the Employment Adjustment Allowance (a subsidy now known as the Employment Adjustment Assistance Allowance) was frequently utilized for employers who were compelled to temporarily shut down operations due to economic downturn and this program significantly contributed to the maintenance of employment security. The main focus of employment policy is to maintain employment and prevent unemployment, rather than to absorb unemployment which has already occurred. This is consistent with Japan's vocational training policy, which does not stress public vocational training for the unemployed to facilitate their finding new jobs, but prefers measures to support companies in conducting on-the-job or off-the-job training, which enables the employers to retain their workers.

The view that dismissals are condoned only as a last resort is widely and deeply rooted in Japanese society. For instance, in 1993, faced with the recession triggered by the collapse of the bubble economy, some Japanese employers canceled their tentative employment agreements with new graduates who were yet to begin their employment. These unilateral cancellations drew public attention and were exposed through wide media coverage as violating social norms. The Ministry of Labor publicized the names of the companies that had canceled their tentative agreements to hire, which subjected these companies to the social stigma attached to such actions. It would be more appropriate to state that case law and government employment policy has been a outgrowth of the prevailing practices respecting the employment security.

4.2. Changing Employment Security and New Developments in Regulations on Contingent Workers and in Case Law on Dismissals

4.2.1. Increasing Mobility in Employment and Labor Market Deregulation

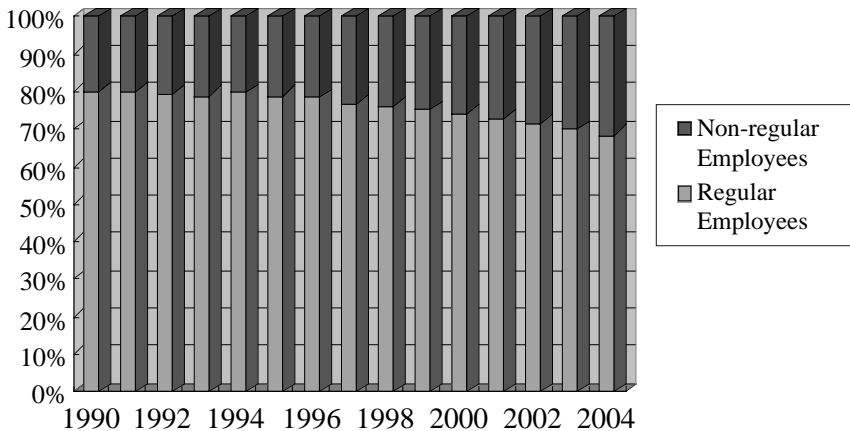
Employment is becoming more unstable, and atypical or non-regular employment is increasing. In 1990, non-regular employees made up 20.2 percent of the Japanese work force, whereas in 2004 this had risen to 31.5 percent (See Figure 4). To cope with increased lateral mobility, the Japanese government has provided a series of measures to activate the

external labor market.²³

The regulations on fixed-term contracts in Japan were originally quite relaxed. Unlike many European countries where objective grounds are required to conclude a fixed-term contract, in Japan no objective ground is required to conclude and renew fixed-term contracts. The sole legal restriction on fixed-term contracts was that the agreed term of the contract should not exceed one year. Therefore parties to a contract could not agree to a two year term, although it was and is completely legal to conclude a 6 month contract and to renew it three times. However, the 2003 revision of the Labor Standards Law further relaxed the upper limit of the agreed term from one year to three years.²⁴

Worker dispatching businesses engaged in labor hire were first legalized in Japan by the enactment of the Worker Dispatching Law (WDL). After several moderate revisions in the 1990s, the 1999 revisions of the WDL generally liberalized worker dispatching by lifting the general prohibition. The 2003 revisions further legalized worker dispatching to production sites, which was prohibited under the 1999 revision.²⁵

Figure 4: Ratio of Regular/Non-regular Employees



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, Labor Force Survey

²³ Araki 1999, 5.

²⁴ Nakakubo 2004, 4.

²⁵ Mizushima 2004, 12.

4.2.2. New interpretation Relaxing Economic Dismissal Restriction

Recently, there has been a noteworthy development in case law concerning economic dismissals. Traditionally, as mentioned above, the validity of economic dismissals depends on whether all four requirements are met or not. If one of four requirements is not satisfied, the dismissal has been regarded as an abuse of the right to dismiss.

A recent decision rendered by the Tokyo District Court²⁶ rejects this interpretation because, it says, there is no solid legal ground for insisting that all four requirements must be satisfied for economic dismissals. According to the Tokyo District Court, what the court should determine is whether a dismissal is abusive or not. The so-called “four requirements” are merely “four factors” to analyze abusiveness. Therefore, according to the position of the Tokyo District Court, if one of the “four factors” (for example, consultation) is not met, such an economic dismissal can still be held legal and valid by taking all other factors surrounding the dismissal into consideration.

This new approach by the Tokyo District Court has provoked heated discussion and particularly severe criticism from labor-oriented lawyers. However, more and more decisions by courts and scholarly opinions support a “four factors” rule rather than a “four requirements” rule. They consider the inevitable necessity for corporate reorganization to cope with structural changes in the economy.

Having stated that, from a comparative view, even if the “four requirements” rule becomes “four factors” rule, restrictions nevertheless will still be more stringent than in the United States²⁷ and probably more so than in Germany.²⁸

²⁶ The *National Westminster Bank* case (3rd Provisional Disposition), 782 *Rodo Hanrei* 23 (Tokyo District Court, January 21, 2000).

²⁷ In the United States, the classic employment-at-will doctrine is certainly eroding and is being modified by case law. Stringent anti-discrimination laws also restrain American employers from arbitrarily dismissing employees. However, compared to situations in European countries and Japan, American employers still enjoy more freedom to dismiss employees and there is hardly any restriction on economic dismissals. See Summers 1995, 1036; Schwab 2003, 177.

²⁸ Though German law requires detailed procedures for economic dismissals including establishing a “social plan,” if employers follow those procedures it seems easier to reduce redundant employees in Germany than in Japan. As a matter of practice, economic dismissals accompanied by a settlement payment are widespread. *E.g.* Neef 2000, 8.

4.3. Countermeasures Protecting Employees' Interests

It is noteworthy that several countermeasures against the promotion of corporate reorganization and increase in labor mobility have been adopted for protecting employees' interests in the last few years.

4.3.1. Labor Contract Succession Law of 2000

To facilitate corporate restructuring and reorganization to cope with the sluggish Japanese economy, the so-called "corporate division scheme"²⁹ was introduced by amendment to the Commercial Code in 2000. However, it was feared that the corporate division scheme could be easily abused for downsizing or streamlining of redundant workers and employment security would be severely damaged. Therefore, to protect employees' interests in the event of corporate division, the Labor Contract Succession Law (LCSL) was enacted with effect from April 1, 2001. Under the LCSL, employment relations are, under certain conditions, automatically transferred to the newly-established corporation.³⁰

Since the LCSL prescribes automatic succession of employment relations to a newly established or succeeding company, the LCSL can be seen as a Japanese version of the EC directive on transfer of undertakings. However, there are significant differences between the EC directive and the LCSL. The most important difference is that the LCSL application is confined to divisions of corporations, whereas the EC directive covers not only merger and division of corporations but also transfer of undertakings. Under the Japanese law, unlike EU law, automatic and mandatory transfer of an employment contract is not required in the event of transfer of undertakings.

Compared to the situation in the United State where no employment

²⁹ Prior to the 2000 revision of the Commercial Code, corporation division was carried out through transfer of business or undertakings. However, in order to transfer business, the transferor corporation must obtain individual consent of all creditors as well as those of workers transferred to the transferee corporation. Such cumbersome procedures were thought to have hindered corporate restructuring and reorganization in Japan. The 2000 revision of the Commercial Code introduced simplified procedures for the division of corporation. When a corporation division plan is approved by the shareholders meeting by special resolution, corporation division becomes legally binding on all parties concerned without obtaining their individual consent, though dissenting creditors can express objection and seek liquidation.

³⁰ As for the details of the LCSL, see Yamakawa 2001, 6; Araki 2003, 27; Araki 2004a, 69.

protection is provided in the process of corporate restructuring,³¹ it is notable that the Japanese legislature thought it necessary to provide certain protection for employees in the event of division of corporation. In the process of enacting the legislation, a fair balance between the necessity of promoting corporate reorganization and the protection of employees was sought and the midway between the EU and US approach was adopted.

4.3.2. The 2003 Revision of the Labor Standards Law

The 2003 revision of the Labor Standards Law (LSL) made the case law rule on abusive dismissals an explicit provision in the Law. A new provision (Art. 18-2) was inserted into the LSL: “In cases where a dismissal is not based upon any objectively reasonable grounds, and is not socially acceptable as proper, the dismissal will be null and void as an abuse of right.”

In the tripartite Council Deliberating Working Conditions which *de facto* determined the contents of the government’s bill, the labor side sought to introduce provisions declaring the “four requirements” rule on economic dismissals. However, as mentioned above, the “four requirements” rule is developing into a “four factors” rule, and thus the management side strongly opposed stating a “four requirements” rule in the Law. Consequently, no agreement was made in the tripartite council for establishing a new provision concerning economic dismissals.

The bill drafted by the government had put the following sentence before the above-quoted provision nullifying abusive dismissals: “Employers can dismiss their employees providing that the Law and other enacted laws do not restrict their right to dismiss.” However, labor unions, opposition parties, the Japan Federation of Bar Associations and other bodies raised objections, contending that this sentence could give the impression that employers have a free hand in dismissals. Government parties yielded and eliminated the sentence.

The 2003 revision of the LSL also introduced provisions requiring clarification of grounds for dismissals (Art. 89 No. 3) and obliging the employer to deliver a certificate stating the reasons for dismissals upon the

³¹ Schwab 2003, 183.

employee's request even during the period between the notice of dismissal and the date of leaving employment (Art. 22 Para. 2).

Labor unions and labor scholars had long argued for the necessity to enact laws expressly requiring a just cause for dismissals, because of the lack of transparency in a contradictory situation where enacted laws did not require any just cause but case law *de facto* did. However, their proposals had never been adopted by the legislature in the past. This time, the plan to revise the LSL to clarify the dismissal rules was raised by the Koizumi cabinet and its Council for Regulatory Reform. They intended to relax the case law rules which, they thought, were so rigid that they hindered structural changes entailing mobilization of the workforce.

Since the labor unions were arguing for a strengthening of dismissal regulations, naturally they strongly opposed relaxing the case law rule by new legislation. As to a new proposal to introduce monetary solutions to resolve dismissal disputes, which was also suggested by the Council for Regulatory Reform and requested by the management side, the tripartite council could not reach an agreement and no legislative proposal was made on monetary solutions. In the result, what the tripartite council agreed was to write down precisely the above-mentioned basic principle of the case law, namely an abuse of the right to dismissal being null and void, without mentioning rules on economic dismissals or monetary solutions.

The government proposal (LSL Art. 18-2) stated as follows: "An employer may dismiss a worker where his right to dismiss is not restricted by this Law or other laws. Provided that a dismissal shall be treated as a misuse of that right and invalid, where the dismissal lacks objectively rational grounds and is not considered to be appropriate in general societal terms." However, during deliberations in the Diet, the first part of the proposed Art. 18-2 which declares the employer's right to dismiss was feared to have the declaratory effect of encouraging dismissals. As a result, the first part was deleted and the enacted Art. 18-2 reads "A dismissal shall, where the dismissal lacks objectively rational grounds and is not considered to be appropriate in general societal terms, be treated as a misuse of that right and invalid."

Considering the crystallization of non-written case law as an explicit provision in the LSL, the omission of the part of the Bill stating the

employer's right to dismissal, and other revisions requiring clarification of dismissal reasons (Art. 89 No. 3) and notification of them to dismissed workers (Art. 22 Para. 2), the overall direction of the 2003 LSL revisions was in fact to counterbalance increasing mobility of the workforce.³²

5. Industrial Relations, Employee Participation and Corporate Governance

The prominent feature of Japan's industrial relations is stable and cooperative relations between labor and management. Japan's current stable industrial relations can be understood as the result of the following three factors: (1) Japan's enterprise unionism; (2) widespread joint labor-management consultation practices; and (3) internal management promotion practices, which has already been mentioned.

5.1. Enterprise Unionism

Enterprise unionism is a system in which unions are established within an individual enterprise, collectively bargaining with a single employer, and concluding collective agreements at the enterprise level. According to the statistics as of 1997, 95.6 percent of unions in Japan are enterprise-based unions and 91.2 percent of all unionized workers belong to enterprise unions.³³

An enterprise union organizes workers in the same company irrespective of their jobs. As a result, both blue and white collar workers are organized in the same union. Enterprise unions normally confine their membership to regular workers though there are no legal obstacles which prevent enterprise unions from organizing part-time workers or temporary workers.

Although there are several historical reasons for the dominance of enterprise unionism, the main reason is that it has served well as a key component of Japanese employment relations. Under the long-term employment system, dismissals are avoided at all cost. In exchange, workers accept the flexible adjustment of working conditions. In the highly

³² The opinions on the effect of the 2003 revision is divided. Compare Hanami 2004, 13 and Nakakubo 2004, 14.

³³ Ministry of Labor 1997.

developed internal labor market, employees are transferred within a company and receive in-house education and on-the-job training. The promotion and wages of each employee are decided mainly by that individual's length of service and performance. In this context, industrial-level or national-level negotiations have made little sense. Enterprise unions and enterprise-level collective bargaining have been the most efficient mechanism in reconciling the requirements of an internal labor market with the workers' demands.

When unions have their basis in a particular company, they tend to be more pragmatic than ideological and more conscious about their own company's productivity and competitiveness.

Enterprise unionism has several defects, such as weak bargaining power, the lack of a universal impact across the industry or nation, and the lack of social and political influence on national labor policy.³⁴ To compensate for the weakness in bargaining power and lack of industry or nation-wide impact of collective bargaining, union leaders devised in 1955 a unique wage determination system called "*Shunto*" (the spring wage offensive).³⁵ Joint labor-management consultation at the industrial and national level and official tripartite deliberation councils where the content of government labor policy and drafts of labor legislation is deliberated and decided also function compensatory mechanism for the limited influence of enterprise unions.³⁶

³⁴ Sugeno and Suwa 1996. Hanami severely criticizes enterprise unions for having ignored the interests of non-regular employees who have mostly remained unorganized. See Hanami 2004, 4.

³⁵ Under the *Shunto* system, every spring, industrial federations of enterprise unions and national confederations set the goal for wage increases and coordinate the time schedule of enterprise-level negotiations and strikes across enterprises and industries. According to the schedule, strong enterprise unions in a prosperous industry are chosen as a pace setter to commence negotiations and set the market price for that year. Other unions then follow suit. The market prices established in *Shunto* have also been reflected in the public sector where strikes are prohibited, and also in regional minimum wages which are revised every fall by the tripartite Minimum Wages Council within the framework of the Minimum Wages Law. In this manner, the *Shunto* strategy has compensated for the limitations of enterprise unionism in terms of bargaining power and establishing social standards across companies. For details of the historical development and economic analysis of *Shunto*, see Takanashi 2002.

³⁶ Araki 2004a, 72.

5.2. Joint Labor-Management Consultation

At plant and company level, Joint labor-management consultation is an established practice in Japanese industrial relations and this complements collective bargaining over terms and conditions of employment. According to the survey in 1999, 41.8 percent³⁷ of all surveyed establishments have such consultation bodies.³⁸ In unionized establishments, the figure is greater at 84.8 percent. In many countries, labor-management consultation was not voluntarily established. Therefore, the state intervened and forced companies to establish works councils or other channels for communicating and informing employees. In Japan, by contrast, labor-management consultation is voluntary and operates without any legal supports.

The origins of this system are to be found in the period of conflict after the Second World War. By the mid-1950s, leaders on both sides of industry had become increasingly unhappy with the tendency towards adversarial relations and had begun to look for new, more pragmatic and cooperative relations. In 1955, the Japan Productivity Centre was established by business circles under the auspices of the Ministry of International Trade and Industry (MITI) and the American authorities in order to promote joint consultation and productivity improvements. Left-wing union confederations, especially *Sohyo*, were skeptical and regarded the movement as a new type of rationalization or exploitation. However, the confederation of moderate unions (*Sodomei*), agreed to participate on the conditions that consultation should not be used to bypass unions and that their opinions should be fully respected. Thus, three basic principles were agreed. One, labor-management consultation should be promoted in order to increase productivity. Two, productivity increases should enhance employment security, with any problems of surplus labor being resolved by transfers and the like rather than by lay-offs. Three, the fruits of increased productivity should be distributed fairly between the firm, employees, and customers, in accordance with the conditions in the national economy.

³⁷ The figure is smaller than that in the previous survey in 1994 (55.7%). This is mainly because of the difference in the size of surveyed establishments. The 1994 survey sampled establishments with more than fifty employees and the 1999 survey sampled those with more than thirty.

³⁸ Ministry of Labor 1999.

On this basis (and after the defeat of the leftist union movement during the major dispute at the *Miike* coal mine in 1960), pragmatic and cooperative labor relations gradually became established in Japanese industrial relations. Labor and management voluntarily established consultation arrangements and developed extensive communication channels. Employers provided information to employees and their unions, and unions cooperated with management in increasing productivity. However, it should be remembered that joint consultation has been sanctioned the union's right to bargain.

5.3. Recent Developments in Industrial Relations

In industrial relations, there have been no drastic legislative changes except for the very recent revision of the Trade Union Law in November 2004.³⁹ However, recent changes in the environment surrounding industrial relations have led to calls for the reconsideration of the worker representation system.

5.3.1. Legislative Developments Promoting Corporate Restructuring

First, from the late 1990s, the Japanese government took a series of measures to promote corporate restructuring or reorganization and market-oriented management in order to cope with the prolonged economic slump. In 1997, a stock option system was introduced and the previous prohibition of genuine holding companies was liberalized by the revision of the Anti-Monopoly Law. The year 1999 saw the advent of the Industrial Revitalization Special Measures Law which encouraged and supported business revitalization and the Industrial Rehabilitation Law which prevented bankruptcies and rehabilitated companies in failing circumstances. In the same year, the stock exchange and transfer systems were introduced to facilitate forming the holding company system. As already discussed, the corporate division scheme was introduced in 2000 to promote corporate reorganization and an option to adopt a US-type corporate governance was introduced in 2002.

³⁹ The 2004 revision of the Trade Union Law strengthens the power of labor relations commissions and expedites the remedial procedures of unfair labor practice cases. However the revision did not change any part of the representation mechanism.

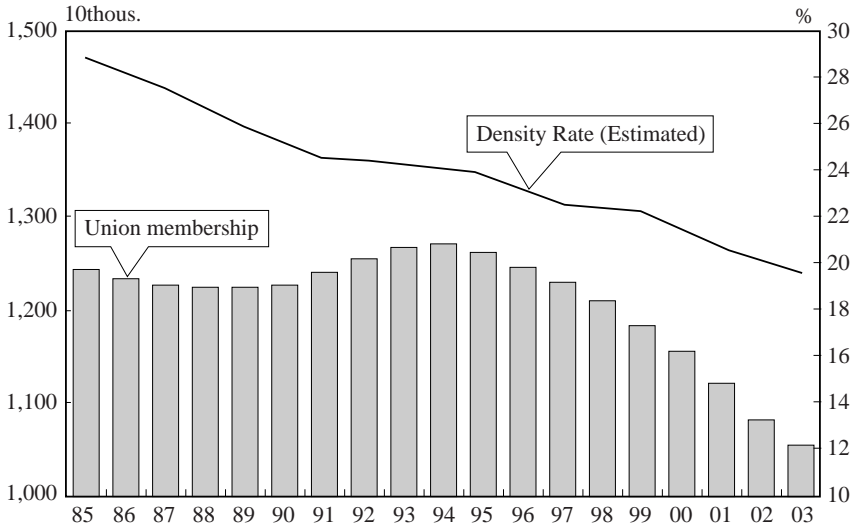
This series of legislative changes aimed to promote corporate reorganization, which inevitably affected industrial relations. A trend emerged whereby a company is divided into several units and each unit becomes an independent company, while the headquarters of the original company becomes a holding company governing the newly created subsidiaries. When an enterprise union does not respond to such corporate reorganization, there will be an absence of collective bargaining because there may be no union members in the newly established company. One recent legal debate concerns whether a union that organizes workers in the subsidiary company can legally request collective bargaining with the holding company. According to the traditional interpretation, when there is no evidence that the holding company has actually intervened in and decided the working conditions of the subsidiary, the holding company does not bear the duty to bargain with the union organizing workers in the subsidiary company. However, since the holding company can decide upon the existence or abolition of the subsidiary as a decisive shareholder, some scholars argue for the holding company's duty to bargain.

5.3.2. Declining Union Density and Emerging New Representation System

Second, the unionization rate has continuously declined since 1975 and finally reached below 20 percent (19.6% in 2003, see Figure 5). Further, the diversification of the workforce has led to questions as to the representative legitimacy of enterprise unionism. Traditionally enterprise unions solely organized regular employees and non-regular workers such as part-time workers and fixed-term contract workers remained unorganized. However, currently 30 percent of all employees are non-regular employees. The target of corporate restructuring in the 1990s concentrated on middle management employees. Employees promoted to middle management are supposed to leave unions. Therefore they are provided little protection by labor law and labor unions. These circumstances require reconsideration of the channel conveying employees' voice. Some scholars contend that Japan should introduce an employee representation system like the works council in Germany (*Betriebsrat*) which represents all the employees in the establishment

irrespective of union membership.

Figure 5: Union Membership and Density Rate (Estimated)



Source: Ministry of Health, Labor and Welfare, Basic Survey on Labor Unions

The 1998 revision of the LSL introduced a new representation system called a *roshi iinkai* (labor-management committee). Half of the members of this committee must be appointed by the labor union organized by a majority of workers at the workplace concerned, or with the person representing a majority of the workers where no such union exists. The labor-management committee must be established when the employer intends to introduce the discretionary work scheme (management planning type),⁴⁰ which functions as a Japanese counterpart of the white-collar exemption from overtime regulations. The labor-management committee is the first permanent organ with equal membership for labor and management that represents all the employees in the establishment. Therefore, this committee can be regarded as the embryonic form of a Japanese works council, although the jurisdiction of this committee is currently confined to regulation of working hours and its establishment is

⁴⁰ There are two types of discretionary work scheme: professional work type and management planning type. For details, see Araki 2002, 94 and Shimada 2004, 56.

not compulsory.

Since the procedures to adopt the discretionary work scheme are very complicated, currently there are very few labor-management committees. However, the 2003 revision of the LSL simplified the procedure to introduce the discretionary work scheme. Previously, decision making in the committee was by unanimous agreement, but under the revised LSL, it can be achieved by four-fifths majority among the committee members. Although it remains to be seen whether the labor-management committee will become more common and solidify as a system of employee representation, the introduction of this embryonic form of representation by recent legislative change is noteworthy.

6. Conclusion: Future of Japan's Practice-Dependent Stakeholder Model

6.1. Current Situation of the Japan's Practice-Dependent Stakeholder Model

As mentioned at the outset, Japan's employee-centered stakeholder model relies heavily on a number of customary practices such as long-term cross-share ownership, internal promotion of management and acceptance of dual-function directors into the management board, long-term (lifetime) employment, and voluntary joint labor-management consultation.

This article has reviewed how these practices formed and sustained the traditional stakeholder model in Japan. It then examined recent changes that might affect the traditional governance model. It is true that considerable changes are taking place. As for the structure of shareholdings, cross-shareholdings are being dissolved, and foreign investors are increasing. The revision of the corporate law in the 1990s to facilitate shareholders representative suits necessitates a style of corporate governance which is more conscious of shareholder value. After the collapse of bubble economy, together with a shift from indirect finance via banks to direct finance, the importance of Japanese banks in corporate governance has been reduced. In these circumstances, it is no surprise that shareholder value has surfaced as a new criterion.

Drastic revisions to the corporate law have given large companies the

option of adopting a US-type corporate governance system utilizing outside directors, which might also change the nature of the management. The employment system in Japan is also experiencing transformation. In the last decade, Japan repeatedly achieved the worst-ever unemployment figures. Lateral mobility has increased and the state's labor market policy has tilted toward the activation of the external labor market. Courts have started to relax restrictions on economic dismissal. Stable regular employment has gradually shrunk and currently non-regular and contingent workers account for 30 percent of all workers. In the area of collective labor relations, the decline in union density and the diversification of the workforce is progressing and might require reconsideration of the traditional collective labor relations system.

Compared to a legally-sanctioned stakeholder model like that in Germany, Japan's practice-dependent stakeholder model is more vulnerable to environmental changes. Although a socio-economic system consisting of interdependent institutions is transformed into another only with difficulty,⁴¹ in an era of disequilibrium, when several institutions change simultaneously, such change might occur. Therefore, the question is whether or not the aforementioned changes will lead to fundamental institutional changes that transform the current stakeholder model into the shareholder-value model.

6.2. Future of the Japanese Corporate Governance

Given the existence of countermeasures working against shareholder value-oriented governance, and various research results discussed below, the most likely outcome is that the current stakeholder model will survive for the time being. Recent changes and developments can best be viewed as the realignment of the priority of various stakeholders' interests in the framework of the stakeholder model. A number of countermeasures and tendency may be cited.

First, although cross-shareholdings are dissolving, more than 80 percent of surveyed companies still maintain cross-shareholdings and they recognize the merit of forming stable and long-term trading relations. The 2001 revision of the Commercial Code limits directors' liability in a

⁴¹ Aoki and Okuno 1996, 1.

shareholders representative suit. Although the 2002 corporate law revisions introduced the US-style governance model, the vast majority of Japanese corporations maintain the traditional model. As for employment security, the enactment of the Labor Succession Law in 2000 was a systemic countermeasure to protect employees' interest in the face of increasing corporate reorganizations. The 2003 revisions of the Labor Standards Law that incorporate the case law rule on abusive dismissals have a symbolic significance to explicitly confirm the norm consciousness of employment security in Japanese society. Declining labor unions and workforce diversification call for new forms of worker representation. In this regard, a labor-management committee system introduced in 1998 attracts attention as to whether or not it will develop into a Japanese version of the works council representing all employees in the establishment. These developments serve to sustain the stakeholder model centered on employees' interests or at least put a brake on the radical transformation into the shareholder value model.

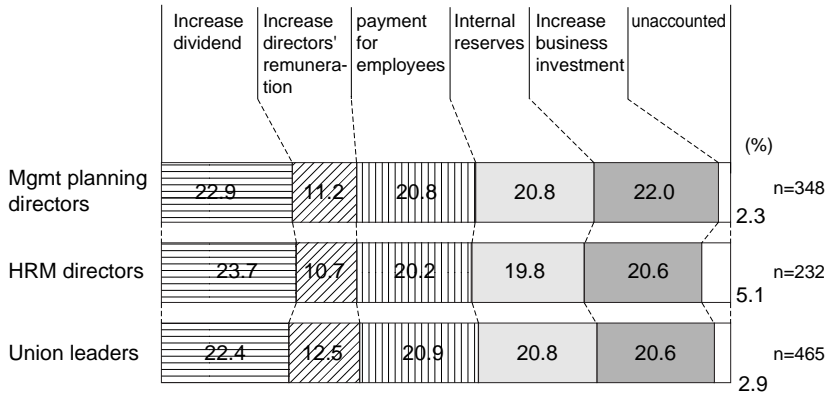
Second, several recent surveys prove that, the stakeholder model is still supported widely in Japanese society despite some moves towards a shareholder-value model.

According to one survey,⁴² when a corporation has increased profits, they are not supposed to be distributed solely to shareholders but to be distributed almost evenly to shareholders, employees, internal reserves, and business investments. Such a view is supported not only by union leaders but also by management planning directors and HRM directors (see Figure 6).

According to the same survey, when asked about "recent changes within your company in the last three years," about 70 percent of the respondents indicated that their company had "adopted performance-based or achievement-based HRM" or had "adopted corporate restructuring or reorganization measures," but only 26 percent of them responded that their company "paid special consideration to the shareholders in management decision-making."

⁴² the JPC-SED 2003 survey.

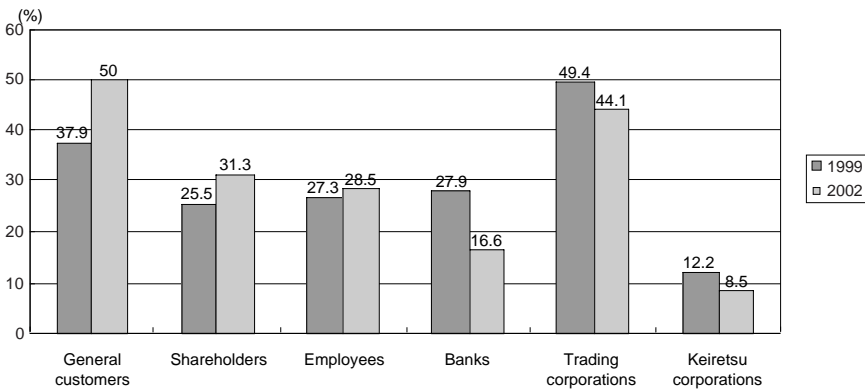
Figure 6: To Whom the Increased Profit Should Be Distributed



Source: JPC-SED 2003.

Another Survey⁴³ found that while banks and trading companies have become less important and customers and shareholders regarded as more important between 1999 and 2002, employees are still regarded as an equal stakeholder. Indeed, there is evidence that their perceived importance is rising (see Figure 7). As for the external control of corporate governance, it is also notable that customers and product markets are seen as more important than shareholders or the stock market.

Figure 7: Who is the Important Stakeholder?

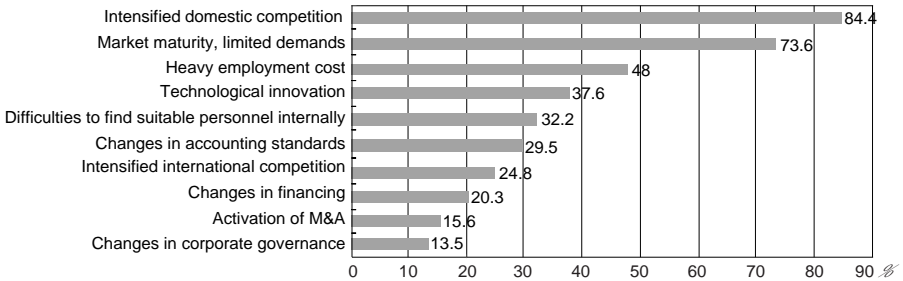


Source: Ministry of Finance, Policy Research Institute 2003.

⁴³ Ministry of Finance, Policy Research Institute 2003.

The Japan Institute of Labor examined the factors affecting restructuring and downsizing decisions. Prominent factors are not changes in corporate governance (14%) but intensified competition in the domestic market (85%) and ‘limited demand due to market maturity’ (74%) (See Figure 8).

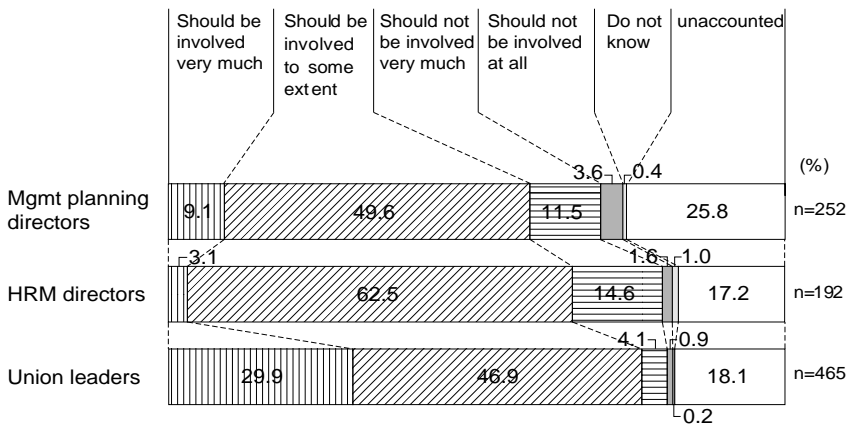
Figure 8: Factors Affecting the Corporate Restructuring Entailing Staff Downsizing



Source: Japan Institute of Labor 2002.

In terms of industrial relations, the JPC-SED 2003 survey showed that a majority of directors think labor management consultation does not hinder management decision-making. Moreover, not only the majority of the union leaders but also 58.7 percent of management planning directors and 65.6 percent of HRM directors replied that labor unions should be involved in management decision-making into the future. The negative responses are quite small in number (see Figure 9). This survey was conducted in July and August of 2001 when the Enron and WorldCom scandals had not yet come to light and US-style corporate governance was receiving its greatest accolades in the Japanese media. It is remarkable that, at such a time, labor and management at the workplaces still recognized the value of union involvement. This seems to reflect the deep-rooted consciousness in Japan that employees are an important constituent of corporations.

Figure 9: How Far Labor Unions Should Be Involved in Management Decision-making in the Future



Source: JPC-SED 2003.

Given these survey results together with the various countertrends and countermeasures for protecting employees' interests in the course of corporate restructuring, the author considers that Japan's stakeholder model will not be drastically modified in the near future. Current changes in shareholder structure and management machinery certainly require the reconsideration of priority orders of various stakeholders' interests. Shareholders' interests cannot be ignored any more and employment security is no longer an absolutely supreme value in corporate governance. However, such reconsideration seems to be occurring within the framework of the stakeholder model, and it is not likely that the model will completely convert into the shareholder value model at least for the time being.

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