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**Re-examining Legal Transplants:  
The Director's Fiduciary Duty in Japanese Corporate Law**

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Abstract

*The transplantation of legal rules from one country to another is commonly observed around the world. Legal transplants can range from the wholesale adoption of entire systems of law to the copying of a single rule. Despite the importance of transplants to legal development around the world, scholarly understanding of this ubiquitous form of legal development is still fairly rudimentary. For example, there is little agreement among scholars on transplant feasibility and the conditions for successful transplants, or even how to define "success." Moreover, there is little analysis of how the success or failure of legal transplants relates to the achievement of larger goals, such as economic development.*

*Japanese law, particularly the legal rules governing economic organization, is a prime example of the transplant phenomenon, both in its systemic and single-rule variations. Japan imported its original Commercial Code (including legal rules on business corporations) from Germany in 1898 as part of a fundamental reform of its legal system, and made large-scale amendments to the corporate law in the immediate post-war period by importing many specific legal rules from the United States. This article attempts to shed light on the role of legal transplants in corporate law by examining Japan's transplantation of a single corporate rule: the director's duty of loyalty, which was added to the Commercial Code in 1950 as a direct import from the United States. For almost forty years after it was transplanted, however, the duty of loyalty was never separately applied by the Japanese courts, and played little role in Japanese corporate law and governance. It finally began to be used in the late 1980s, long after Japan had achieved high economic growth. Using a simple theory of legal transplants, we explain the initial non-use and subsequent use of the duty of loyalty transplant in Japanese corporate law.*

*Part I of the paper provides a simple analytical framework for determining the success or failure of a legal transplant. Part II takes up the specific case study of the*

*transplantation of the duty of loyalty into Japanese corporate law. It begins with a brief examination of the central role of duty of loyalty doctrine in U.S. corporate law. We then contrast the situation under Japanese corporate law, tracing the duty of loyalty from its transplantation to its eventual application by the Japanese courts. Part III evaluates the transplantation of the duty of loyalty in Japan in light of our theoretical discussion.*

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**Introduction**

The transplantation of legal rules from one country to another is commonly observed around the world. Legal transplants<sup>1</sup> can range from the wholesale adoption of entire systems of law to the copying of a single rule. Japanese law, particularly the legal rules governing economic organization, is a prime example of the transplant phenomenon, both in its systemic and single-rule variations. Japan imported its original Commercial Code (including legal rules on business corporations) from Germany in 1898 as part of a fundamental reform of its legal system, and made large-scale amendments to the corporate law in the immediate post-war period by importing many specific legal rules from the United States.

Despite the importance of transplants to legal development around the world, scholarly understanding of this ubiquitous form of legal development is still fairly rudimentary. As Alan Watson, the most prominent contributor to the

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<sup>1</sup> We define a legal transplant as a body of law or individual legal rule that was copied from a law or rule already in force in another country, rather than developed by the local legal community. For a host of reasons (including most basically a lack of familiarity among the local legal community charged with interpreting and enforcing it), a legal transplant might “behave” differently than a locally developed body of law or rule.

transplants literature, has noted, while “[t]he act of borrowing is usually simple...build[ing] up a theory of borrowing on the other hand, seems to be an extremely complex matter.”<sup>2</sup> For example, there is little agreement among scholars on transplant feasibility and the conditions for successful transplants, or even how to define “success.” Moreover, there is little analysis of how the success or failure of legal transplants relates to the achievement of larger goals, such as economic development.

This article attempts to shed light on the role of legal transplants in corporate law by examining Japan's transplantation of a single corporate rule: the director's duty of loyalty.<sup>3</sup> In 1950, Japan added to its Commercial Code a new statutory provision, Article 254-3, as a direct import from the U.S.<sup>4</sup> Article 254-3 provides: "directors owe to the company the duty to perform their functions faithfully, in compliance with laws, the company's charter provisions, and resolutions of shareholders' meetings." The importation of this provision in an attempt to improve Japanese corporate law is not surprising: the duty of loyalty is central to U.S. corporate law, playing a major role in addressing agency costs associated with the corporate form. As we will see below, however, for almost forty years after it was transplanted, the duty of loyalty was never separately applied by the Japanese courts, and played little role in Japanese corporate law and governance. It finally began to be used in the late 1980s, long after Japan had achieved high economic growth. This suggests that transplanting this core U.S. corporate law rule did not contribute to Japan's post-war economic success, although it apparently did not detract from that success either.

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<sup>2</sup> Alan Watson, *Aspects of Reception of Law*, 44 *Am. J. Comp. L.* 335, 335 (1996).

<sup>3</sup> In this chapter, we focus on the transplantation of a specific rule as opposed to systemic transplants of entire bodies of law. As discussed below, we believe it is difficult to meaningfully analyze the success or failure of systemic transplants.

<sup>4</sup> As originally enacted, this provision was Article 254-2 of the Commercial Code. It was renumbered Article 254-3 by amendments to the Code in 1981. For convenience, we use the latter Code provision throughout this article.

Understanding whether and how this specific transplant worked has significance beyond Japanese corporate law. Today, there is growing discussion of the possibility that greater attention to fiduciary duties could enhance corporate governance in many countries, with attendant analysis of the feasibility of transplanting fiduciary principles.<sup>5</sup> More broadly, Japan is widely viewed as a rare example of a “successful legal transplant,” yet there is very little analysis of what this means, beyond the fact that subsequent to Japan’s enactment of a European code system, it developed into a highly prosperous and politically stable nation. Deeper analysis of Japan’s experience with the transplantation of the duty of loyalty standard may advance both debates.

In Section I, we review existing literature and provide a simple analytical framework for determining the success or failure of a legal transplant. In Section II, we turn to our specific example. We begin with a brief examination of the central role of duty of loyalty doctrine in U.S. corporate law. We then contrast the situation under Japanese corporate law, tracing the duty of loyalty from its transplantation to its eventual application by the Japanese courts. In Section III, we evaluate the transplantation of the duty of loyalty in Japan in light of our theoretical discussion. Section IV is a brief conclusion.

## **I. Some Elements of a Theory of Legal Transplants**

Alan Watson is right—building a theory of legal transplants is hard. Although the discussion in this section represents only a first step toward a systematic mode of analysis, we believe it provides a useful way to begin thinking

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<sup>5</sup> For example, both Korea and Taiwan transplanted the duty of loyalty into their commercial codes in the wake of the Asian financial crisis by copying the Japanese Article 254-3. For scholarly discussions of fiduciary duty transplants, see, e.g., Lynn Stout, *On the Export of U.S.-Style Corporate Fiduciary Duties to Other Cultures: Can a Transplant Take?*; Katharina Pistor and Changgang Xu, *Transplanting the Concept of “Fiduciary Duty:” Evidence from Transition Economies*, both in Curtis J. Milhaupt, *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (2003).

about the transplant phenomenon. We begin by asking why transplants are a major form of legal development. Next we briefly discuss existing explanations for the phenomenon, noting some shortcomings in these approaches. Finally, we provide a simple conceptual framework for determining the success or failure of a specific legal transplant.

Why are legal transplants ubiquitous? Several interrelated answers are possible. First and most obviously, they are a cheap, quick and potentially fruitful source of new law (particularly given the possible learning effects associated with the foreign rule), and may be the only feasible means of law reform in some instances (the “practical utility” motivation). Second, this form of legal change often follows colonization or military occupation (the “political” motivation). Third, law reform is typically the province of the legal profession (broadly defined to include lawyers, judges, and ministry of justice officials), and this has implications for legal borrowing. As one commentator puts it, “all law making, apart from legislating, desperately needs authority,”<sup>6</sup> and law borrowed from an esteemed foreign source often fills that need among the legal profession (the “symbolic” motivation). Finally, some rules are transplanted in haste and without adequate preparation or familiarity with the operation of the rule in the home country (“blind copying”). As we will discuss below, the motive for a transplant, as well as the motives of the legal professionals charged with its subsequent application and enforcement, have implications for its success or failure.

Indeed, the literature reveals fundamental disagreement on transplant feasibility. Commentators are split between those who proclaim the feasibility of transplantation as a device of legal change, and those who claim that they are impossible. In large measure, this debate reflects disagreement about the relationship of law to the society in which it exists. At one extreme is the optimism of Alan Watson, who views law as existing apart from political and social institutions, and primarily significant for its authoritative qualities. For Watson, “the transplanting of legal rules [by which he means both individual rules and large parts

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<sup>6</sup> Alan Watson, *Aspects of Reception of Law*, 44 *Am. J. Comp. L.* 335, 346 (1996).

of a legal system] is socially easy.”<sup>7</sup> At the other extreme are skeptics who take the position that “rules cannot travel [because their meaning is culture-specific]. Accordingly, ‘legal transplants’ are impossible.”<sup>8</sup> Between these two extremes, several intermediate positions are also present in the literature. Otto Kahn-Freund argues that distinctive “environmental” conditions in each country—particularly the political environment in the form of constitutional structure and interest group coalitions—make successful transplants rare.<sup>9</sup> Finally, the economically oriented commentator Ugo Mattei has suggested that legal borrowing can be best explained as a movement toward efficiency. That is, competition in a “market for legal culture” determines which rules are transplanted from abroad; the most efficient legal doctrine survives around the world.<sup>10</sup>

While these perspectives are valuable, neither optimists nor skeptics have drawn on rigorous theory in support of their positions. Watson’s optimism rests on several questionable assumptions, including (a) that what matters most is the *idea* behind the law being transplanted, rather than the law itself,<sup>11</sup> and (b) that “many legal rules make little impact on individuals.”<sup>12</sup> At the same time, the view that legal transplants are impossible is contradicted by a variety of empirical evidence. And while it may be true that efficient legal rules survive and proliferate around the world, this fact (even if true) does not address the *conditions* under which a particular legal rule is efficient in a given country.

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<sup>7</sup> Alan Watson, *Legal Transplants: An Approach to Comparative Law* 95 (1993).

<sup>8</sup> Pierre Legrand, What “Legal Transplants”?, in *Adapting Legal Cultures* 55, 57 (David Nelson and Johannes Feest eds., 2001).

<sup>9</sup> Otto Kahn Freund, On Uses and Misuses of Comparative Law, 37 *Modern L. Rev.* 1 (1974). By politics, Kahn Freund means constitutional structure of government as well as interest group pressures.

<sup>10</sup> Ugo Mattei, Efficiency in Legal Transplants: An Essay in Comparative Law and Economics, 14 *Int’l Rev. L. & Econ.* 3 (1994).

<sup>11</sup> Alan Watson, *Comparative Law and Legal Change*, 37 *Cambridge L.J.* 313, 315 (1978).

<sup>12</sup> Alan Watson, *Legal Transplants: An Approach to Comparative Law* 96 (1993).

So we turn to the main question: What are the conditions of successful legal transplants? Obviously, “success” depends on the baseline one uses for measurement, and this too is controversial.<sup>13</sup> Here, we take success to mean simply use of the imported legal rule in the same way that it is used in the home country, subject to adaptations to local conditions. Conversely, failure occurs when the imported rule is ignored by relevant actors in the host country, or the application and enforcement of the rule lead to unintended consequences. This definition is broad enough to countenance “success” where law contributes to the development of social norms but is otherwise unenforced. We stress that by defining the terms “success” and “failure” in this way, they carry no normative implications. Our aim here is simply to explain why transplants are used or ignored, not to evaluate the economic consequences of their use or nonuse. Indeed, as we will discuss in our transplant case study below, it is not obvious that heavy reliance on the duty of loyalty is optimal in the corporate law of the host country (United States). Thus, it is difficult to draw normative conclusions about the initial nonuse and subsequent use of the duty of loyalty transplant in the host country (Japan).

We believe that “fit” between the imported rule and the host environment is crucial to the success of a transplant. A rich and dynamic analytical conception of “fit” might provide traction on the question why some transplants are used and others are ignored. “Fit” might be thought of as having two components—micro and macro. *Micro-fit* is how well the imported rule complements the preexisting legal infrastructure in the host country. *Macro-fit* is how well the imported rule complements the preexisting institutions of the political economy in the host country.

Central to analysis of both micro-fit and macro-fit is the *availability of substitutes*. The fewer the available substitutes for the transplanted rule, either within the legal system (in the form of other laws and legal procedures) or outside the legal system (in the form of norms, informal state interventions, or market constraints), the more likely it is that the transplanted legal rule or institution will be

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<sup>13</sup> See David Nelken, Towards a Sociology of Legal Adaptation, in *Adapting Legal Cultures* 7, 37-39 (David Nelken and Johannes Feest eds., 2001).

adapted to local conditions and thus used by relevant actors in the host country.

*Motivation* is also highly relevant to the analysis. Motivation must be analyzed both from the perspective of the law reformers initially responsible for the transplant, and the legal actors (courts, attorneys, government officials) with the potential to make use of it. From the former perspective, the more predominant practical utility is in the mix of motives for the transplant, the more likely it is that the transplant will be successful from the outset, if only because motivation is likely to affect law reformers' attention to micro-fit. Other motives, such as politics or symbolism, are far less conducive to success. Yet the initial motivation for the transplant (whether conducive to success or not) can be overcome by those with the authority to apply or enforce the law subsequent to its codification in the local regime. Thus, motivation is an ongoing issue.

Having sketched a few theoretical ideas on transplantation as a device of legal change, we now turn to an important example, the transplantation of the duty of loyalty from U.S. to Japanese corporate law.

## **II. The Duty of Loyalty: From U.S. to Japanese Corporate Law**

### **A. The U.S.**

As Robert Clark notes, "Directors, officers, and, in some situations, controlling shareholders owe their corporations, and sometimes other shareholders and investors, a fiduciary duty of loyalty. This duty prohibits the fiduciaries from taking advantage of their beneficiaries by means of fraudulent or unfair transactions."<sup>14</sup>

This duty plays a large role in U.S. corporate law. It is the key doctrinal desideratum of some of the most venerable (or at least well known) cases of the

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<sup>14</sup> Robert C. Clark, *Corporate Law* 141 (1986).

Delaware courts.<sup>15</sup> It ranges over vast areas of the standard U.S. law school course, from the treatment of self-interested transactions and corporate opportunities, through executive compensation and controlling shareholder problems, to the sale of control and corporate combinations.<sup>16</sup>

Not only is the duty of loyalty appropriately deemed central to *existing* U.S. corporate law, it is viewed as a key facilitator of the ongoing *development* of U.S. corporate law. To quote Clark again: “Most importantly, this general fiduciary duty of loyalty is a residual concept that can include factual situations that no one has foreseen and categorized. The general duty permits, and in fact has led to, a continuous evolution in corporate law.”<sup>17</sup>

In the process of occupying large tracts of U.S. corporate law, duty of loyalty jurisprudence—particularly as developed by the Delaware courts—has also greatly influenced the structure of corporate governance and transactional mechanics in the United States. The cases provide numerous legal incentives for directors facing conflicts of interest to structure the deal substantively and procedurally to approximate an arm’s-length transaction.<sup>18</sup> It is widely accepted, for example, that Delaware’s approach to the duty of loyalty has influenced the use of independent committees of directors and the retention of independent legal and financial advisors in corporate transactions.

The influence of the duty of loyalty on U.S. corporate law and governance is all the more striking given that there is widespread dissatisfaction with the actual

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<sup>15</sup> E.g., *Guth v. Loft*, 5 A.2d 503 (Del. 1939); *Sinclair v. Levien*, 280 A.2d 717 (1971); *Weinberger v. UOP, Inc.*, 409 A.2d 701 (Del. 1983); *Revlon v. McAndrews & Forbes*, 506 A.2d 173 (Del. 1985).

<sup>16</sup> See, e.g., Melvin A. Eisenberg, *Corporations and Other Business Organizations*, Eighth Edition Unabridged (2000).

<sup>17</sup> Clark, *supra*, at 141.

<sup>18</sup> See E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor’s Role*, 45 *Bus. Law.* 2065 (1990); Edward Rock and Michael Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 *U. Pa L. Rev.* 1619, 1662-3 (2001).

state of the law. In the words of one commentator, “Perhaps no area of corporate law is as beset with conflicting judicial opinions, variations among statutes, and confusion and uncertainty concerning the likely outcome of litigation as is the duty of loyalty.”<sup>19</sup>

This last point raises a puzzle within U.S. corporate law—precisely how and why does the duty of loyalty work? Two points should be made. First, not all scholars agree that it does in fact work well as an organizing legal principle of corporate governance.<sup>20</sup> Second, even in the United States, the duty of loyalty has undergone a substantial transformation over the past century, from an outright prohibition against transactions that pose a conflict of interest to a flexible standard applied *ex post* by the courts. Interestingly, the duty of loyalty is itself a legal transplant in U.S. corporate law—not a cross-border transplant of the type we are discussing in this article, but a cross-doctrinal transplant from the law of trusts.<sup>21</sup>

## B. Japan

As noted above, Article 254-3 of the Commercial Code was imported from the U.S. in 1950. The exact process by which this provision was transplanted is not entirely clear from the historical record, but the U.S. Occupation authorities in charge of corporate law reform sought inclusion of this provision as part of a package of reforms designed to improve minority shareholders’ rights under the Japanese Commercial Code.<sup>22</sup> The Occupation authorities were apparently not

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<sup>19</sup> A. A. Sommer, Jr., *The Duty of Loyalty in the ALI’s Corporate Governance Project*, 52 *Geo. Wash. L. Rev.* 719, 719 (1984). Henry Hansmann and Reinier Kraakman note the “notoriously vague and open-ended U.S. case law that articulates the fiduciary dut[y] of loyalty...” Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 *Geo. L.J.* 439, 459 (2001).

<sup>20</sup> E.g., Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 *J. L. Econ. & Org.* 55 (1991).

<sup>21</sup> Edward Rock and Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 *Nw. U. L. Rev.* 651 (2002).

<sup>22</sup> See generally Masafumi Nakahigashi, *Shoho Kaisei Showa 25/Showa 26* [The 1950-51

satisfied that the pre-existing provisions on the duties of directors were adequate, and perhaps since the duty of loyalty was considered to be one of the most important provisions in U.S. corporate law, a decision was made to codify it in the Japanese Code.<sup>23</sup> There is no evidence that this provision was controversial or even widely debated at the time of the transplant.<sup>24</sup>

Several interesting developments subsequent to the introduction of Article 254-3 into the Code should be noted. First, the provision generated a large amount of doctrinal discussion among commentators concerning whether a director's duty of loyalty in Article 254-3 [*chujitsu gimu*] is different from the preexisting duty of care under Article 254(3) (which incorporates Civil Code Article 644) [*zen kan chui gimu*]. The details of this debate are beyond the scope of this chapter. But a famous Supreme Court decision of June 24, 1970 adopted the view that Article 254-3 clarifies and restates the duty of care—it does not constitute a separate or higher duty for corporate directors.<sup>25</sup> Equally importantly, as discussed below, until a new trend emerged, the Japanese courts never separately applied the duty of loyalty in Article 254-3. In each case where it was cited, the court simultaneously cited the duty of care provision, so the meaning of Article 254-3 was not clear and its application had no practical significance.<sup>26</sup>

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Amendments to the Commercial Code].

<sup>23</sup> See Michiyo Hamada, in 6 *Shinpan Chushaku Kaishaho* 27-28 (1987).

<sup>24</sup> See Nakahigashi, *supra*. It is possible that Article 254-3 was not controversial because the U.S. and Japanese negotiators attributed different meanings to this provision. The Americans may have believed they were introducing a new duty into the corporate law, while the Japanese may have viewed the provision as an amplification of specific, pre-existing legal duties. There is no specific evidence of such a failure in “meeting of the minds,” although this interpretation is consistent with the subsequent events detailed in the text.

<sup>25</sup> 24 *Minshu* 625 (Yahata Seitetsu Case) (In a shareholder derivative suit challenging a steel company's political donation to the ruling Liberal Democratic Party, the Court held that the donation was not a violation of the directors' duty of care or loyalty.)

<sup>26</sup> To be precise, there was one case prior to the trend discussed in text below in which a court stated in passing that the director had violated the duty of loyalty, without reference to the duty of

Second, even prior to the 1950 amendments, the Commercial Code contained important rules governing director conduct. These include Articles 264 (regulation of competition), 265 (regulation of self-dealing) and 269 (regulation of compensation). After Article 254-3 was introduced, commentators viewed these specific provisions as special applications of the general duty of loyalty principle under Article 254-3, and the courts often applied these specific provisions. This leads to the fundamental question: why did Japanese corporate law need Article 254-3?

Third, as a matter of legal change, the statutory language of Articles 264 and 265 was altered several times subsequent to the 1950 amendments, while Article 254-3 has never been altered. It must be noted that most statutory changes in Japanese corporate law are motivated by domestic forces and reasons rather than pressure or other forces from outside Japan; the original Commercial Code and the 1950 amendments are exceptions.

Fourth, Articles 264 and 265 provide procedural ex ante rules. Under Article 264, when a director engages in an activity in the same line of business as that of the company, he must disclose the facts and obtain ex ante approval of the board of directors.<sup>27</sup> Similarly, when a director attempts to engage in a self-dealing transaction—for example, the purchase of land from the company—he must disclose the facts and obtain ex ante approval of the board of directors. In most cases applying the relevant provisions of the Code, the courts struggled with such issues as the activities covered by Articles 264 or 265, and the effect of a transaction where the director had not complied with the procedural requirements of Article 265.

In contrast, Article 254-3 is a standard—a legal provision that is only given

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care. However, the court is not precise in its analysis, and holds the director liable to his company for the commission of a tort. Osaka High Court, March 3, 1983, 1084 Hanrei jiho 122.

<sup>27</sup> Shareholders' approval was required until an amendment in 1981.

content ex post, by an adjudicator who determines both the bounds of permissible conduct and factual issues related to the dispute.<sup>28</sup> In the U.S., the duty of loyalty is judicially enforced ex post, and courts have wide discretion to fashion appropriate procedural requirements and remedies in the absence of specific statutory guidance. By contrast, courts in civil law jurisdictions, including Japan, tend to grant only those remedies explicitly recognized in the statutes. While this difference in judicial mindset can be exaggerated, it is fair to say that at least historically, common law judges have been more comfortable than their civil law counterparts in working with open-ended standards. In order for a standard to take hold in a civil law system, it must overcome the predisposition of judges working in such systems to apply specific provisions of the code in favor of more general provisions.

Yet any simple explanation of why the transplant of Article 254-3 was initially unsuccessful—for example, that Articles 264 and 265 served as adequate substitutes, or a standard like Article 254-3 has a high enforcement cost because Japan lacks an active judiciary—must contend with the confounding reality of more recent developments. In a well-known case in 1989, the Tokyo High Court gave separate application to Article 254-3 (that is, without coupling it with any other provision) and awarded damages to the aggrieved company.<sup>29</sup> In this case, a director of a computer support company resigned to set up his own firm. He successfully persuaded several key employees of his former firm to move to his start-up. The Court ruled that poaching key employees was a violation of the director's duty of loyalty to his former company as provided in Article 254-3, and held him liable to the company for damages.

Doctrinally, the court appeared to assume that Article 264—which regulates “competition” with the firm in the same line of business—does not reach the distinct activity of luring employees away from the firm. Thus, there was room for the application of Article 254-3, despite the existence of a more specific provision in the

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<sup>28</sup> See Lewis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *Duke L. J.* 557 (1992).

<sup>29</sup> Tokyo High Court, October 26, 1989, 835 *Kinyu shoji hanrei* 23.

Code. In the U.S., this sort of case would probably be handled by the doctrine of corporate opportunity. In Japan, however, as shown by this case, the scope of Article 264 is too narrow to cover all corporate opportunity cases. So Articles 254-3 and 264 are not perfect substitutes even for the sub-group of self-dealing cases known as corporate opportunity.<sup>30</sup>

Transplantation of the general duty of loyalty provision was not accompanied by the remedial rules recognized in the United States. One common remedy when the duty is breached in the U.S. is disgorgement of the director's profits rather than damages to the firm. In Japan, however, the violation of Article 254-3 implicates Article 266(1)(v) – providing only for the payment of damages. This reduced the practical significance of applying Article 254-3 (duty of loyalty) apart from Article 254(3) (duty of care).

Nevertheless, after the above-mentioned landmark case, in some factually similar cases, the courts have applied Article 254-3 independently and awarded damages for breach of the duty of loyalty.<sup>31</sup> In a different context, one court held that a director of an insurance company violated the duty of loyalty by revealing nonpublic corporate information to the media, and awarded damages to the company.<sup>32</sup> Thus, it is fair to say that Article 254-3 now plays an important role in Japanese corporate law, though the scope of application of the duty of loyalty is still more limited than in the United States.

The extent to which a director's activity in relation to corporate opportunities should be regulated is a difficult question, and U.S. case law is complex (some would say confused) in this respect. Our point here is simply that courts must exercise wide discretionary power in resolving corporate opportunity and other self-dealing cases, and the relevant law in the U.S. relies heavily on

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<sup>30</sup> Note that there is a case where the court applied both Article 254-3 and Article 264. See Maebashi District Court, March 14, 1995, 1532 Hanrei jiho 135.

<sup>31</sup> See, e.g., Tokyo District Court, February 22, 1999, 1685 Hanrei jiho 121.

<sup>32</sup> Tokyo District Court, February 15, 1999, 1675 Hanrei jiho 107.

“standards” for this purpose. The Tokyo High Court case is a watershed in the history of Japanese corporate law in that the court exercised ex post judicial intervention, U.S. style, to control director conflicts of interest. In subsequent cases, Japanese courts have followed its lead, finding directors liable for breach of the general duty of loyalty standard in Article 254-3.<sup>33</sup>

### III. Evaluation

The discussion above raises a puzzle. Why was Article 254-3 dormant in Japan for almost forty years after it was transplanted? And why was it suddenly awakened from its long slumber in the late 1980s? There is no evidence that the Japanese judiciary abruptly became more activist in the 1980s.<sup>34</sup> It is also highly unlikely that directors suddenly became “more greedy” at this time.

Our theoretical discussion of legal transplants allows us to shed at least some light on this puzzle. We hypothesize that at the time the duty of loyalty was transplanted and throughout the period of high economic growth, conditions were not ripe for success (as we have defined the term). However, by the late 1980s, a variety of legal, economic, and institutional changes began to improve the micro-fit between the duty of loyalty standard and the legal infrastructure, and the macro-fit between the duty of loyalty standard and the institutions of the political economy.

At the time of the transplant in 1950, the micro-fit between Article 254-3 and the existing legal infrastructure was not close.<sup>35</sup> As noted above, the duty of

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<sup>33</sup> A computer search revealed five reported cases finding directors liable for breach of the duty of loyalty following the seminal Tokyo High Court decision. In numerous other cases, plaintiffs alleged violation of Article 254-3, but the court held for the defendant directors.

<sup>34</sup> One commentator suggested that the development of the capital markets in the 1980s in Japan might have affected judicial “mindset,” leading to the more expansive view of the duty of loyalty. While this is plausible, it is virtually impossible to verify.

<sup>35</sup> Japanese corporate law commentators recognized this point long ago. See Yazawa, *supra*, at 557 (speculating that the nonuse and underdevelopment in Japan of judicially applied standards to

loyalty provision is a standard. The application of a standard, particularly one as open-ended and vague as the duty of loyalty (which in essence simply prohibits “selfish” behavior on the part of directors), places high demands on the legal infrastructure. At a minimum, that infrastructure must include a viable derivative suit procedure and attorney incentives to bring such suits; judges and attorneys familiar with the use of broad legal standards as opposed to narrowly tailored rules; and courts capable of detecting and fashioning remedies for self-dealing in the absence of explicit statutory guidance. This infrastructure was not highly developed at the time of the transplant. The law reformers appear to have been motivated primarily by politics (Article 254-3 was introduced under military occupation) and symbolism (as noted above, it was generally thought that the duty of loyalty was an important rule in the U.S.). Notably lacking was a practical motivation for the transplant. There is no historical evidence that curbing managerial expropriation of shareholders was a chief concern of the occupation’s corporate law reformers, who seemed principally concerned about advancing “shareholder democracy” in Japan. The Japanese legal community itself did not seem concerned by this problem. The lack of a clear practical motive for the transplant may have lessened the reformers’ attention to micro-fit, and dampened the incentives of the local legal community to make the duty of loyalty standard an integral part of the legal system.<sup>36</sup>

At a macro-level, the duty of loyalty was orphaned by the distinctive institutions characterizing Japan’s high economic growth period, which helped prevent the taking of corporate opportunities and other self-dealing by directors. High growth may itself have discouraged the taking of corporate opportunities, because the rewards of remaining with a company were high. Conversely, the lifetime employment system, in which rewards were directly tied to seniority and

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regulate directors’ fiduciary obligations is the result of the legal education system, judicial training, and the administration of justice).

<sup>36</sup> For example, although a derivative suit mechanism was transplanted in the 1950 amendments to the Commercial Code, plaintiffs were required to pay a high filing fee to initiate such suits. This dampened incentives to bring this type of litigation until the fee was lowered in the early 1990s.

lateral career opportunities were limited, made it costly to leave the firm and establish a competing company.<sup>37</sup> Moreover, managers operating on thin margins in highly competitive, export-oriented markets, or operating under extensive governmental oversight, may have been unable to extract rents for personal consumption. While takeovers provide managers with opportunities to reap significant gains from one-time disloyal conduct, such transactions were rare in post-war Japan due to cross-shareholding arrangements, virtually eliminating opportunities for this form of managerial rent extraction.<sup>38</sup> Thus, it is not evident that there were significant corporate fiduciary lapses to be addressed by the legal system in the high-growth period.

Both micro-fit and macro-fit were also affected by the existence of partial substitutes for the duty of loyalty standard. For example, as noted above, the Commercial Code contained specific provisions covering at least a subset of the conduct addressed by Article 254-3. Note, for example, that if the concept of “competition” in Article 264 were broader, the Tokyo High Court may have resolved the erstwhile seminal case on poaching employees to form a new venture without resort to Article 254-3, postponing this important doctrinal development. Efficient private substitutes for some corporate law rules may also have existed outside the legal system, weakening macro-fit. One of us has argued that a series of non-legal rules (“norms”) governing the conduct of Japanese firms in the high-growth period was a reflection of the “transplant effect,” in which unfamiliar legal rules are bypassed by the legal community and private sector.<sup>39</sup> These norms—including the main bank system of contingent corporate monitoring (at least in crisis situations), the lifetime employment system, and social constraints on takeovers--

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<sup>37</sup> See Ronald J. Gilson and Mark J. Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 *Colum. L. Rev.* 508 (1999) (a labor market closed to lateral movement complements the lifetime employment system).

<sup>38</sup> See J. Mark Ramseyer, *Takeovers in Japan: Opportunism, Ideology, and Corporate Control*, 35 *UCLA L. Rev.* 1 (1987).

<sup>39</sup> Curtis J. Milhaupt, *Creative Norm Destruction, The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 *U. Pa. L. Rev.* 2083 (2001).

dampened the demand for corporate law and legal professionals. In so doing, they relieved pressure for the creation of a closer micro-fit between the provisions of the Commercial Code—including the duty of loyalty—and the surrounding legal infrastructure.<sup>40</sup>

However, over time the micro- and macro-fit between the duty of loyalty and other Japanese institutions became closer, substitutes became less viable, and motivations were altered. At a micro-level, the legal community gained experience and became more comfortable with the use of a standard such as Article 254-3. The derivative suit mechanism was reformed.<sup>41</sup> The existence of a growing body of precedent highlighted the distinctness of the duty of loyalty from the duty of care, motivating legal professionals to use the transplanted provision more extensively and in new situations. At a macro-level, high growth was followed by prolonged recession and the extralegal structure for Japanese corporate governance weakened, changing the incentives of managers and increasing the demand for corporate law.

Our analysis suggests that the importance of the duty of loyalty in Japanese corporate law doctrine will continue to grow outside the realm of corporate opportunity, although it is difficult to predict the pace of this development. For example, as shareholder activism and takeovers increase (further tightening macro-fit between the legal standard and the political economy of Japan), the duty of loyalty is likely to become a more central and actively utilized corporate governance principle in Japan.

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<sup>40</sup> To cite just one example, duty of loyalty jurisprudence in the United States advanced significantly during the takeover boom of the 1980s. In a system where hostile takeovers are virtually unknown due to cross-shareholding practices or social norms, courts will face fewer opportunities to give content to the abstract command of the duty of loyalty.

<sup>41</sup> Note that the derivative suit mechanism was altered to lower enforcement costs in 1993, but this development occurred *after* the seminal case and its early progeny, so lower enforcement costs alone do not explain why the duty of loyalty was activated in Japanese corporate law.

While we are obviously working from a very limited empirical base in a single case study, this account of Japan's transplantation of an important corporate law from the U.S. casts doubt on the accuracy (or at least universality) of existing attempts to explain the transplantation phenomenon. Contrary to Watson's view, it was not the *idea* that was important in this transplant—the duty of loyalty concept already existed in several specific provisions of the Japanese Commercial Code. And Watson's claim that law generally does not matter beyond its symbolic importance is refuted by our example and numerous other empirical studies. Thus, the basis for his contention that transplanting law is "socially easy" is open to question. Contrary to Kahn Freund's analysis, politics (defined on his terms as constitutional structure of government and interest group dynamics) played virtually no role in the initial non-use and eventual utilization of this transplant. Moreover, Mattei's efficiency perspective does not contribute significantly to the analysis of this transplant episode. While efficient rules may indeed tend to survive and proliferate outside their home jurisdictions, this bare fact has little explanatory power in the absence of a fine-grained examination of how a specific rule fits into the existing legal infrastructure and political economy of a given system, and the alternatives available to relevant actors.

Rather, at least in this limited example, the success or failure of the legal transplant varied over time, and was determined largely by the degree to which the transplant fit the prevailing legal and non-legal infrastructure of which it was a part. This observation, while not entirely surprising, has several important implications that run counter to the existing literature.

First, measuring the success or failure of a legal transplant may take decades of observation. Japan's experience with the duty of loyalty shows that even a poorly motivated and ill-fitting legal transplant may become a core rule in the host country over time, as the legal infrastructure and political economy change. This occurs as legal and non-legal developments alter the mix of substitutes available and affect the motivation of the legal professionals who interpret and enforce the transplant.

For other countries experimenting with the codification of the duty of loyalty as a means of improving corporate governance, this lesson could either be reassuring and discomfoting. For Korea and Taiwan, which recently imported the duty of loyalty by copying Article 254-3, the Japanese experience may suggest that the duty of loyalty is poised to play a role in corporate governance. The legal and political-economy environments of these countries bear many similarities to those of Japan, suggesting that micro- and macro-fit are conducive to success of the transplant. For countries less far along the path of judicial development and with classes of investors and lawyers less motivated to use this tool of corporate governance, Japan's long, dormant post-transplant period may be more representative of the role the duty of loyalty will play in their corporate law systems in the coming decades. Of course, it is possible that other institutions in these systems might already exist or develop to provide adequate substitutes for judicial enforcement of this legal standard.

Second, the analysis here suggests that, contrary to the approach of most scholars to date, it is virtually impossible to discuss the "success" or "failure" of wholesale transplants of entire bodies of law (such as Japan's transplantation of codes in the European civil law tradition in the late 19<sup>th</sup> century), or to extrapolate meaningfully from a single rule to the feasibility of legal transplants in general. Each legal rule or institution must be examined individually, and assessment of the overall feasibility of legal transplants as a form of legal change requires a more rigorous theoretical base than existing literature has provided. We hope this paper constitutes at least a step toward the formation of such a base.

#### **IV. Conclusion**

In this chapter, we have re-examined the legal transplant phenomenon by analyzing the movement of a single legal rule from U.S. to Japanese corporate law. We have developed a simple analytical framework using the concept of "fit" to evaluate the conditions for the success or failure of a legal transplant, and employed the framework to explain why the duty of loyalty transplant failed for four decades to take hold in Japanese corporate law, but suddenly emerged as an

important rule. The increasing use by the legal community of broad legal standards such as that provided in Article 254-3 of the Commercial Code is one indication of the broad transformation under way in the Japanese legal system and political economy.

We hope this re-examination of the duty of loyalty deepens understanding of the influence of foreign law on the Japanese legal system, and spurs further theoretical and empirical work on the role of transplants in legal adaptation.