

OLD IDEAS DIE HARD?: AN ANALYSIS OF THE 2004 REFORMATION OF SECURED TRANSACTIONS LAW IN JAPAN AND ITS IMPACT ON BANKING PRACTICES*

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INTRODUCTION

Since the turn of the millennium, Japanese law has experienced a fast and fundamental reformation. This general overhaul of the judicial system and the paralleling reform of specific areas such as corporate law,¹ consumer protection,² intellectual property,³ and conflict of law rules proceeded

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1. Eiji Takahashi & Madoka Shimizu, *The Future of Japanese Corporate Governance: The 2005 Reform*, 19 J. JAPANESE L. 35 (2005).

2. Souichirou Kozuka & Luke Nottage, *Re-Regulating Unsecured Consumer Credit in Japan: Over-indebted borrowers, the Supreme Court, and New Legislation*, Sydney Law School Research Paper No. 07/62, available at SSRN, <http://ssrn.com/abstract=1019392> (last visited Apr. 12, 2009).

3. See, e.g., Agency for Cultural Affairs, *Outline of the Law for Partial Amendment of the Copyright Law*, 30 AIPPI J. 148 (2005); Teruhisa Motomiya, *Trademark Law Amended in 2005*, 31 AIPPI J. 63 (2006); Legislative Affairs Office, *General Affairs Division, General Affairs Department, Japan Patent Office, Outline of the "Partial Amendments of Design Act and Other IP-related Acts"*, 31 AIPPI J. 220 (2006); Copyright Division, Commissioner's Secretariat, Agency for Cultural Affairs, *Law to Revise a Part of the Copyright Act*, 32 AIPPI J. 123 (2007).

concurrently.⁴ The law on secured transactions was no exception. In 2004 the Law on Special Rules to the Civil Code Concerning the Perfection of the Assignment of Receivables⁵ was amended to add provisions on the filing of transfer of titles in movables. The title of the law was also renamed the Law on Special Rules to the Civil Code Concerning the Perfection of the Transfer of Movables and Assignment of Receivables (“PTMAR”).⁶ The amended law went into force on October 3, 2005.⁷

The apparent purpose of PTMAR, in accordance with the global trend, was to enhance the efficiency of using movables as securities.⁸ This global trend has largely been inspired by the success of the Uniform Commercial Code (“UCC”) Article 9 in the United States.⁹ As compared with jurisdictions outside the

4. Koji Takahashi, *A Major Reform of Japanese Private International Law*, 2 J. PRIVATE INT’L L. 311 (2006); Yasuhiro Okuda, *Reform of Japan’s Private International Law: Act on the General Rules of the Application of Laws*, in 8 Y.B. PRIVATE INT’L L. 145, 145–46 (Petar Sarcevic *et al.* eds., 2006) (describing the movement for change in secured transactions law); Masato Dogauchi, *Historical Development of Japanese Private International Law*, in JAPANESE AND EUROPEAN PRIVATE INTERNATIONAL LAW IN COMPARATIVE PERSPECTIVE 27 (Juergen Basedow *et al.* eds., 2008); Hironori Wanami, *Background and Outline of the Modernization of Japanese Private International Law*, in *id.* at 6; Masato Dogauchi, *New Private International Law of Japan: An Overview*, 50 JAPANESE ANNUAL OF INT’L L. 3 (2008).

5. Saiken Jôto no Taikô Yôken ni kansuru Minpô no tokurei tô ni kansuru Hôritsu [Law on Special Rules to the Civil Code Concerning the Perfection of the Assignment of Receivables], Law No. 104 of 1998.

6. Dôsan oyobi Saiken no Jôto no Taikô Yôken ni kansuru Minpô no tokurei tô ni kansuru Hôritsu [Law on Special Rules to the Civil Code Concerning the Perfection of the Transfer of Movables and Assignment of Receivables], Law No. 104 of 1998 as amended and renamed by Law No. 148 of 2004.

7. Saiken Jôto no Taikô Yôken ni kansuru Minpô no tokurei tô ni kansuru Hôritsu no Ichibu wo Kaiseisuru Horitsu no Shikô Kijitsu wo Sadameru Seirei [Cabinet Order providing the Date of Entry into Force of the Law that amends a part of the Law on Special Rules to the Civil Code Concerning the Perfection of the Assignment of Receivables] Cabinet Order No. 293 of 2005.

8. See Nuria de la Peña, *Reforming the Legal Framework for Security Interests in Mobile Property*, NS 4 UNIFORM L. REV. 347, 349–59 (1999) (explaining the problems that many countries are facing in improving access to credit and suggesting the reform of secured transaction law as the solution).

9. See Harry C. Sigman, *Security in Movables in the United States – Uniform Commercial Code Article 9: A Basis for Comparison*, in SECURITY RIGHTS IN MOVABLE PROPERTY IN EUROPEAN PRIVATE LAW 54 (Eva-Maria Kieninger ed., 2004) (pointing out the influence that the UCC has had on various exercises in international and domestic law-making).

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United States, especially Civil Law jurisdictions, the most notable feature of the UCC Article 9 is that, through the use of the filing system, not only immovables but also movable assets can be the subject of a secured transaction without transferring their possession to the creditor. Japanese lawmakers also referred to UCC Article 9 in the course of debates before the current reform.¹⁰

Still, PTMAR differs from the UCC in some important respects. The difference is partly a result of PTMAR's intent to change the existing general rules as little as possible.¹¹ As the background of this article will illustrate, there is still a prevailing understanding in Japan that lenders rely on the "value" of the secured asset. In the United States, however, theoretical analysis has developed, and a secured transaction has come to be understood to address the problem of incomplete information between the borrower and the lender. Thus the old ideas about the secured transaction survived in Japan, notwithstanding the apparent adoption of the filing system of the UCC. This may be the true reason for the difference between the UCC and PTMAR.

This article will explore the features of PTMAR by examining its relationship to UCC Article 9. This exploration will begin with an explanation of the law pre-PTMAR and its related problems. Next, the article will outline PTMAR with a special emphasis on comparing it with UCC Article 9. Then, this article will discuss PTMAR's impact on fields related to secured transactions: banking practices, secured transactions theories, and international private law, an issue not fully realized at the time of the reformation. These issues are yet to be determined by the case law. Whether future case law will move PTMAR closer to the UCC depends on whether the courts can depart from the old ideas about the meaning of secured transactions

10. Kigyō Hōsei Kenkyukai (Tampo Seido Kenkyukai) Houkokusho [Report of the Study Group on Business Law (Study Group of the Law on Secured Transactions)] 12-13 (2003), available at <http://www.meti.go.jp/report/downloadfiles/g30128bj.pdf>.

11. OSAMU MORITA, AMERICA TOSAN TAMPO HO: "SHOKI YUSHISHA YUETSU" NO HORI [The Law on Insolvency and Secured Transactions in the United States: the Doctrine of "Financier Dominance"] 285 (2005). This book contains thorough research on UCC Article 9, including comparisons with Japanese law, to which this article owes a great deal.

and have an exact understanding of the ideas behind the UCC.

I. THE NEED FOR SECURED TRANSACTIONS REFORM BEFORE 2004

This section describes the necessity of PTMAR. Before PTMAR, the two types of security interests that could be created in movables were a pledge codified in the Civil Code and a “transfer by way of security,” which was developed by case law. This section will discuss the problems with these two types of securities. Further, this section illustrates that these problems were the motivation for PTMAR, which aimed to improve secured transactions involving movable assets.

A. Japanese Law Concerning the Use of Movables as Security

Before PTMAR, there were two ways to use movables as security under the Japanese law: pledge and “transfer by way of security.” A pledge is a type of security provided in the Civil Code. The creditor (“pledgee”) shall take possession of the pledged asset until the secured claim is paid. Without delivery of the pledged asset to the pledgee, the pledge shall not take effect.¹² The pledgee can not claim its priority unless it keeps possession of the asset.¹³ In case the debtor (“pledgor”) fails to make timely payment and, as a result, is in default, the pledgee is entitled to sell the asset and collect its claim from the proceeds¹⁴ or acquire the asset itself to discharge the debtor.¹⁵ When enforcing its claim in either way, the pledgee shall resort to the court.¹⁶

12. Minpō [Civil Code], art. 344. The creation of a pledge shall take effect by delivering the subject matter of the same to the obligee.

13. Pledgees of movables cannot assert their pledges against third parties unless they are in continuous possession of the thing pledged. *Id.* art. 352.

14. Pledgees shall have the right to possess Thing received from obligors or third parties as security for their claims and to have their own claims paid prior to other obligees out of that thing. *Id.* art. 342.

15. If claims of pledgees of movables are not performed, they may, limited to cases where there are reasonable grounds, demand from a court immediate appropriation of the thing pledged to the performance of the claims in accordance with the evaluation of an appraiser. In such cases, the pledgees of movables must notify the obligors in advance of the demand. *Id.* art. 354.

16. Although there is no statutory provision on this point, remedies without resort to the court are considered “self-help” in Japan and are not allowed except in highly exceptional situations. *See* THE JAPANESE LEGAL SYSTEM 344 (Hideo Tanaka ed., 1976). However, if the creditor agrees with the debtor in

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“Transfer by way of security” is a transaction developed through practice.¹⁷ Though it takes the form of transfer of title, the intent of the parties to the transaction is to provide the creditor (“transferee”) with the security interest. In some cases, the creditor agrees with the debtor (“transferor”) to return the secured asset’s title to the debtor when the debt is paid. In other cases, the debtor may retain the option to acquire the monetary amount equal to the debt and ask the creditor to resell the asset or cancel the sale of the asset and return it to the debtor. In both cases, the transferee appears formally as the new owner of the asset. The court, however, occasionally deviates from such characterization, and it places the transferee in a position similar to the mortgagee under the common law.¹⁸

The asset in which the security interest is created may be a single asset, such as a machine operating in a factory, or in bulk of goods, such as in the case of inventory stored by a distributor. With regard to the latter, the established case law is that the secured interest shall effectively be created if, and only if, the bulk is identified by some criteria, such as kind, location, and amount.¹⁹ When identifying the bulk in this manner, the

advance about remedies available to the creditor in case of default, it is likely that the court will uphold actions taken pursuant to such an agreement, at least under certain conditions. *See* KK Tokyo Mitsubishi Ginko v. Trustee of KK Creative World, 52 (5) Minshu 1261 (Supreme Court of Japan, July 14, 1998) (collection of a promissory note by the bank in accordance with the basic agreement between the bank and its customer (bankrupt debtor) held to have constituted no tort to the latter).

17. A similar idea is found in some other jurisdictions, such as Germany and the Netherlands, though the latter overruled the case law by the amendment to its Civil Code in 1992 and prohibited the transfer by way of security. *See* Julia Rakob, *Germany*, in *CROSS-BORDER SECURITY OVER TANGIBLES* 63, 63–67 (Harry C. Sigman & Eva-Maria Kieninger eds., 2007); Michael Veder, *Netherlands*, in *id.* at 193–94. As regards the German law, *see also* Ulrich Drobnig, *Security Rights in Movables*, in *TOWARDS A EUROPEAN CIVIL CODE* 741, 751 (Arthur Hartkamp *et al.* eds., 3d ed. 2004).

18. Morioka v. Egusa, 1062 Hanrei Jiho 81 (Supreme Court of Japan, Sept. 28, 1982) (allowing the debtor to recover the secured asset by paying off the debt at any time before the asset is sold by the debtor); KK Takamaru v. KK Dairoku, 60 (6) Minshu 2499 (Supreme Court of Japan, July 20, 2006) (holding valid the security interest granted to the second financier in the same asset as that taken as security by the first financier).

19. San’yo Tsusho KK v. Marufuku Reizo KK, 33 (1) Minshu 51 (Supreme Court of Japan, Feb. 15, 1979) (holding that “28 ton of dried leek” without any further specification was not sufficient as identification of the secured movable when the debtor had 44 tons of dried leek in custody of the warehouse

effectiveness of the secured interest in it will not change by bringing in or taking out the individual goods constituting a part of the bulk.

B. Problems Caused by Fictitious Possession and Lack of Notice

By the end of the 1990s, the above situation became unsatisfactory. The banks turned to movables as security for financing small and medium businesses as the price of real property decreased for a decade. The pledge, however, was obviously not appropriate as security in the course of commercial transactions. With the pledged asset under the possession of the creditor (“pledgee”), the debtor (“pledgor”) cannot make use of it. Neither production facilities nor stocks can be offered as a pledge in order to obtain financing.

As regards to the transfer by way of security, the disclosure issue was an impediment, that is, the transfer of a movable as security can go unnoticed. Under the Japanese law, in order for the transfer of ownership in movables to be perfected, the transfer of possession is necessary.²⁰ This transfer of possession includes a fictitious transfer (the previous owner can declare that its possession changes into that of an agent for the new owner).²¹ This could be a problem because there is no change in the appearance, which allows the opportunity for fraud. This fictitious transfer of possession created a loophole for the transferor (“debtor”). The transferor was able to hide the creation of security interest, creating an ability to defraud

operator besides some more possessed by itself).

20. The transfers of real rights concerning movables may not be asserted against a third party, unless the movables are delivered. *Minpō* [Civil Code], art. 178.

21. *Id.* art. 183. If an agent manifests an intention that the thing possessed by it shall thenceforward be possessed on behalf of its principal, the principal shall thereby acquire possessory rights. This rule differs greatly from the American law on secured transactions, under which the security interest cannot be perfected when the secured asset is in possession of the debtor. *See* U.C.C. § 9-313(c). The UCC considers the agency relationship between the creditor and the person possessing the secured asset. As a result, when the person in possession of the secured assets is so closely connected to the debtor that its possession is deemed equivalent to possession by the debtor, the security interest of the creditor is considered not to be perfected. *See* JAMES J. WHITE & ROBERT S. SUMMERS, 4 UNIFORM COMMERCIAL CODE 154 (5th ed. 2002). On the other hand, the Japanese rule is generally applicable to possession in any context, deriving from the rule of *constitutum possessorium* in Roman law.

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another lender into believing that there is no security interest with first-priority. Since the asset appeared to remain in the hands of the debtor, the later lender had no means to examine whether there was a secured creditor. This problem was often referred to as a “lack of public notice,” which could deter commercial financing.

PTMAR was introduced to address the “lack of public notice” problem in order to improve the legal certainty of the type of secured transactions already in existence, that is, transfer by way of security.²² This means that the introduction of PTMAR could have been based on a different theory than the UCC Article 9 of the United States. But such a unique theory did not appear in Japan. In fact, the lack of public notice and whether this truly hindered the secured transaction was not empirically examined before the enactment of PTMAR.

C. The Reasoning Behind American Secured Transactions Reform

The development of the theory of secured transactions, to a great extent, can be traced to the 1999 reform of UCC Article 9. Whether PTMAR brings an equivalent progress in theory is a question worth posing. It is doubtful that the drafters of PTMAR intended a shift in the theory of secured transactions, because PTMAR’s intent was not to affect the principles and case law that had existed before the amendment.

The theoretical arguments in the United States started with the fundamental question of how a secured transaction can enhance efficiency if the information is perfect and a financing contract can be written with completeness. While a secured creditor may lower the interest rate for its loan, reflecting the increased probability of collection, the second creditor will require an increase in the interest rate for its loan. This increase in interest will be for the same amount as the reduction in

22. Commentators often criticize traditional Civil Law jurisdictions for being less efficient, because of a failure to enable the debtor to use movables as securities. *See, e.g.,* Heywood Fleisig, *Secured Transactions: The Power of Collateral*, FINANCE & DEVELOPMENT, June 1996, at 44. This was not the case with Japan, because Japan already allowed movables as securities, there was no need to create a new type of secured transaction. In fact, Japanese lenders had resorted to transfer by way of security of movables for years, in particular when the lender was convinced of the honesty of the debtor.

interest by the first secured creditor, because the second creditor now faces the increased risk in collecting its loan.²³ To put it another way, there is no need for the creditor to use an asset as security, if it can calculate the risk of the debtor accurately.

But when the information with regard to the debtor is *imperfect*, which is ordinarily the case, the secured transaction could enhance efficiency.²⁴ Two separate theories explain this. One theory argues that the security interest can serve as a signal that shows the creditworthiness of the debtor. In order to maintain a secured interest there are various costs on the debtor.²⁵ If the debtor agrees to secure its debt with some of its asset, it may mean that the debtor can afford to accept these costs or perhaps the debtor is confident that he or she will not default, and that enforcement of the secured interest will never take place. In this sense, securing debt with the debtor's asset works as a signal that convinces the creditor of the debtor's creditworthiness. As a result, the debtor can get more loans from the creditor or get a loan under better conditions as compared to an unsecured loan.

Another explanation for how security interests enhance efficiency is that they reduce the agency cost of debts. The agency cost of debt exists because of the possibility that the debtor may replace its assets with more liquid assets and increase the risk of its business after taking a loan from the creditor (asset substitution). A security can prevent the debtor from such an opportunistic behavior of increasing its risk. As a result, the creditor is ensured that the evaluation of the debtor's risk, at the time of the loan's granting, will not be intentionally altered by the debtor later. Such a conviction can again enhance efficiency by giving rise to more loans or loans under better conditions. This theory argues that creating a security interest in

23. See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1149 (1979) (describing how a loan's risk affects the interest rate of the loan).

24. See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEG. STUD. 1, 15 (1981) (stating that secured debt can substitute for incomplete information because it is a signal that the company is able to leverage itself); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEG. STUD. 225, 249-56 (1992).

25. For example, explicit administrative costs (filing fees), and implicit costs of restrictions on the debtor's disposal of the secured asset or the threat of the loss of the asset as a result of the enforcement of the security by the creditor.

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the asset of the debtor assures that a second lender is excluded, thus limiting the debtor from engaging in a second loan and preventing the debtor from changing its exposure to risk.²⁶

Japan's dialogue while creating PTMAR was noticeably different than the United States' dialogue when it created UCC Article 9. The fundamental question during the UCC Article 9 amendments was whether a secured transaction enhances the efficiency of society as a whole. Such a question was never asked in Japan. In Japan, while creating PTMAR, the arguments focused on making the security interest in movable assets more certain and reliable. The efficiency of creating a secured interest itself was implicitly assumed, and it was not considered an issue meriting discussion.

II. UNDERSTANDING THE RESULTS OF THE REFORM: A COMPARISON OF UCC ARTICLE 9 AND JAPANESE LAW

To understand PTMAR's effects, it is useful to compare it to the UCC. First, the filing system (the key feature of PTMAR) will be explained by comparing the details of PTMAR with the filing system under UCC Article 9. Second, the scope of application of PTMAR is compared with that of UCC Article 9, highlighting the differences in the types of transactions covered. A third issue to be discussed is whether PTMAR solved the problems that were identified in the previous section. Strangely enough, the legislature intentionally left those problems unresolved and expected case law to develop an appropriate solution.

A. Solving Lack of Public Notice with a New Filing System

In response to the possibility of transferor ("debtor") deceit, PTMAR introduced a system for filing the transfer of title in movables. PTMAR's language requires a transferor to file with a Registration Office designated by the Minister of Justice.²⁷

26. Hideki Kanda & Saul Levmore, *Explaining Creditor Priorities*, 80 VA. L. REV. 2103, 2104 (1994); George G. Triantis, *A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities*, 80 VA. L. REV. 2155, 2156 (1994).

27. Dōsan oyobi Saiken no Jōto no Taikō Yōken ni kansuru Minpō no Tokurei tō ni kansuru Hōritsu [Law on Special Rules to the Civil Code

The Minister later designated the Tokyo Registration Office.²⁸ When filing for transfer, the possession of the movable is deemed transferred in accordance with the Civil Code. The file is searchable by the trade name of the transferor. In this sense, it is considered a “substantially” debtor-based file.

The asset is identified either by specification or place of the secured asset.²⁹ The requirement of identification under PTMAR is very different from the description of the property required by the UCC Article 9. First, PTMAR requires the parties to “identify” the secured asset at the time of filing. This differs from the UCC because the UCC distinguishes the sufficiency of the description of the property in the financing statement³⁰ from that in the security agreement.³¹

Second, while the indication of “all assets” or “all personal property” is sufficient in the financing statement under the UCC,³² it will not be accepted as a proper file under PTMAR because the secured asset is not identified.

Third, the identification of the asset under PTMAR must exactly refer to the asset in which the security interest is created. Mentioning the kind of asset (such as “CT scan machine”) and

Concerning the Perfection of the Transfer of Movables and Assignment of Receivables], Law No. 104 of 1998 as amended and renamed by the Law No. 148 of 2004 (PTMAR), art. 5(1).

28. Dōsan oyobi Saiken no Jōto no Taikō Yōken ni kansuru Minpō no Tokurei tō ni kansuru Hōritsu dai 5-jō dai 1-kō no Kitei ni yoru Tōkisho no Shitei ni kansuru Ken [Notice about the Designation of the Registration Office according to Article 5, Paragraph 1 of the Law on Special Rules to the Civil Code Concerning the Perfection of the Transfer of Movables and Assignment of Receivables], Ministry of Justice notice No. 501 of 2005.

29. Dōsan, Saiken Jōto Touki Kisoku [Regulation for the Filing of Transfer of Assets and Assignment of Receivables], Ministry of Justice Order No. 39 of 1998 (hereinafter Ministerial Order), art. 8(1) (implementing art. 7(2)5 of PTMAR).

30. U.C.C. § 9-504 (1998).

31. § 9-203. While the financing statement can just state “all assets of the debtor,” that does not suffice as “a description of collateral” in an enforceable security agreement. The latter needs to identify the collateral by (1) specific listing, (2) category, (3) a type of collateral, (4) quantity, (5) computational or allocational formula or procedure or (6) any other method to make the identity of the collateral objectively determinable. U.C.C. § 9-108(b). Therefore, a description such as “all livestock” (category) or “100 tons of coal stored in warehouse X” (quantity) is required in the security agreement, but not in the financing statement. See WHITE & SUMMERS, *supra* note 21, at 106–10.

32. § 9-504(2).

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the serial number or equivalent is necessary.³³ This is in sharp contrast with the UCC, under which the description of the property is inherently evidentiary of the identification of the asset.³⁴

Finally, under PTMAR it is also necessary to identify the place where the goods are stored, as well as the kind of goods.³⁵ In this case, the file is treated as referring to all the assets of the kind stored in the named place. A file mentioning only a part of the goods stored in the place is unacceptable, as it does not sufficiently identify the asset.

It is not surprising that a file with such detailed specificity of the secured asset causes some concerns about data protection. To address such concerns, only the transferor, transferee, and some others with legitimate interests, such as the attaching claimant, can obtain the file.³⁶ Members of the public may request a “summary” of the file from the Registration Office of the place where the head office of the transferor is located.³⁷ This summary merely shows the history of filing without identifying the asset. The idea is that a creditor approached by the debtor can check whether there is a prior holder of the secured interest by requesting a summary of the file before acquiring security interest in the movable. If there is no such file, the creditor has assurance of its priority. If the summary indicates a record of filing, the creditor may require the debtor to supply a copy of the file to show that the existing file does not relate to the exact asset that the creditor is going to acquire security interest in.

33. See Ministerial Order, *supra* note 29, art. 8(1)1. Such a requirement is contrary to the understanding of the UCC that an error in the serial number in the description of the property may not invalidate the security interest. See WHITE & SUMMERS, *supra* note 21, at 109.

34. See Comment 2 to U.C.C. § 9-108 (rejecting “any requirement that a description is insufficient unless it is exact and detailed”).

35. See Ministerial Order, *supra* note 29, art. 8(1)2.

36. Dōsan oyobi Saiken no Jōto no Taikō Yōken ni kansuru Minpō no Tokurei tō ni kansuru Hōritsu [Law on Special Rules to the Civil Code Concerning the Perfection of the Transfer of Movables and Assignment of Receivables], Law No. 104 of 1998 as amended and renamed by the Law No. 148 of 2004 (“PTMAR”), art. 11(2).

37. *Id.* art.11(1).

B. PTMAR's Difference in Scope of Subject Matter

There are also some differences with regard to the scope of the subject matter between PTMAR and UCC Article 9. First, the subject matter of PTMAR is the transfer of title in movables.³⁸ The form of the transaction rather than its economic characteristics defines the scope of application of PTMAR. It includes the true sale of the asset without any intent of creating a security interest of the parties. But PTMAR is applicable only to the transfer by way of security and not other types of secured transactions, such as the reservation of title³⁹ or lease agreement.⁴⁰ This preference of form over substance contrasts with UCC Article 9. Article 9 applies to “a transaction, regardless of its form, that creates a security interest.”⁴¹ This difference between PTMAR and the UCC may be because a typical Japanese law emphasizes form, which is in contrast to the functional approach of law-making in some jurisdictions outside of Japan.⁴² Furthermore, some industry parties, such as the leasing companies, preferred the absence of a filing requirement, and they lobbied against a comprehensive filing system that would be similar to the UCC Article 9.

Second, PTMAR is applicable only when the transferor is a corporation.⁴³ This limitation is derived from the understanding that the purpose of PTMAR is to enhance the efficiency of

38. *Id.* art. 3.

39. Reservation of title is a kind of secured transaction often used in the sale of movables (such as automobiles). The seller retains title to the movable until the buyer makes the payment in full.

40. A lease agreement may not always be a secured transaction, since the transaction may be aimed at the use of the leased asset by the lessee. In some cases, however, the parties borrow the form of “lease” for the purpose of securing a debt, such as in the case of a financial lease.

41. U.C.C. § 9-109(a)(1) (1998).

42. See Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 U. PA. J. INT'L BUS. L. 569, 585–86 (1991) (pointing out that the rule-making in Japan is formalistic rather than substantive, citing the case of securities regulation as an example).

43. *Dōsan oyobi Saiken no Jōto no Taikō Yōken ni kansuru Minpō no Tokurei tō ni kansuru Hōritsu* [Law on Special Rules to the Civil Code Concerning the Perfection of the Transfer of Movables and Assignment of Receivables], Law No. 104 of 1998 as amended and renamed by the Law No. 148 of 2004 (PTMAR), art. 1. When the transferor is a natural person, the secured transaction is governed by the Civil Code alone, as prior to the enactment of PTMAR.

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financing to corporations. Although there could be some arguments for distinguishing the case involving consumers as parties, especially debtors, it is doubtful that there were sufficient reasons to treat natural persons and corporations differently.⁴⁴ The result, nevertheless, is an exclusion of individual merchants from making use of the filing under PTMAR, while an incorporated non-governmental organization or other non-profit organization is entitled to its use.

Third, some kinds of movables are exempt from PTMAR because of the already existing statutes on registration. They are automobiles, aircrafts and ships. While these assets are outside the UCC's scope of application as well,⁴⁵ in the United States the reason for such fragmentation is because these assets belong to federal and not state jurisdiction. As Japan does not have a federal system of government, the similarity on this point appears to be a coincidence. The explanation given by the drafters of PTMAR is as follows: These existing statutes prevail over the Civil Code; because PTMAR is a special rule, it replaces the rules of the Civil Code; as a result, the special statutes prevail over PTMAR, which is a substitute for the Civil Code. It may be doubtful that such fragmentary systems of registration and filing have good reasons to be maintained.

The final difference is that PTMAR's scope is limited to filing. First, it does not extend to enforcement in the event of default, which is the subject of Part 6 of UCC Article 9. Rather, the general rules of procedure continue to govern the enforcement of the secured interest.⁴⁶ Second, PTMAR does not govern the right of the secured creditor to the proceeds; on this issue, the general rules of transfer by way of security govern.⁴⁷ Third, PTMAR has not made any change to the

44. See U.N. Gen. Assembly [GAOR], U.N. Comm'n on Int'l Trade Law, *Security Interests: Terminology and Recommendation of the UNCITRAL Draft Legislative Guide on Secured Transactions*, 13, U.N. Doc. A/CN.9/637 (Sept. 28, 2007).

45. U.C.C. § 9-109(c)(1).

46. Because the form of the transaction is a transfer of title, the secured creditor will appear as the owner of the asset and claim possession when the debtor is in default. As previously mentioned, the general rule of Japanese law is that the creditor should not resort to "self-help" as under the U.C.C. § 9-609(b)(2), but should go to the court. See *supra* note 16.

47. Since the transfer by way of security is not codified in the Civil Code or any other statute, the rules can only be found in cases and doctrines. In *The*

general rule of priority under which the transfer of possession perfects the transfer of a movable and gives the transfer priority over an unperfected transfer. Instead, PTMAR merely provides a constructive rule that when a filing is made with regard to a movable, its possession is deemed to have been transferred.⁴⁸

C. PTMAR's Resolution: Does It Go Far Enough?

PTMAR lacks a provision on protecting a *bona fide* purchaser. This does not mean that the legislature did not care about a *bona fide* purchaser, especially a consumer purchasing goods from a retailer. On the contrary, the general rules protecting a third party acquiring a movable, provided in the Civil Code, remain applicable. Therefore, one acquiring possession of the asset is legitimately entitled to its ownership as long as he or she was not negligent in being unaware of any prevailing right at the time of acquiring the possession of the asset.⁴⁹ The premise for this understanding is that PTMAR should not deprive an acquiring party of the possibility of being regarded as *bona fide*. It is the role of the courts to decide whether or not the failure to check the filing constitutes negligence on the part of the acquiring party, depending on the facts of each case.

Maintaining the general rules on protection of an acquiring third party will diminish the ability of the filing system to remedy the “lack of public notice,” which existed prior to PTMAR. Even after the filing, the secured creditor cannot be fully assured of its security interest in the asset, because an acquiring third party may appear and claim that its purchase was *bona fide*.

PTMAR also failed to reduce the creditor's costs for

Trustee of Kyoko KK v. KK Daiwa Bank, the Japanese Supreme Court held that a bank issuing a letter of credit that had the imported goods transferred to it by way of security was subrogated to the amount payable to the debtor. 53 MINSHU 863 (Supreme Court of Japan, May 17, 1999).

48. *Dōsan oyobi Saiken no Jōto no Taikō Yōken ni kansuru Minpō no Tokurei tō ni kansuru Hōritsu* [Law on Special Rules to the Civil Code Concerning the Perfection of the Transfer of Movables and Assignment of Receivables], Law No. 104 of 1998 as amended and renamed by the Law No. 148 of 2004 (PTMAR), art. 3(1).

49. Minpō [Civil Code], art. 192 (“A person who commences the possession of movables peacefully and openly by a transactional act acquires rights to exercise with respect to such movables immediately if he or she is in good faith and faultless.”).

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confirming, prior to filing, the absence of a previous interest in the asset. As already mentioned, no new rules on priority conflicts have been introduced. The filing does not prevail over other types of transfer of possession, but merely stands on equal footing with the latter. Another creditor could have acquired a security interest in the asset by relying on the traditional fictitious transfer of possession. In such a case, the priority is determined by the timing of the two equally opposable means of perfection: the filing and the (fictitious) transfer of possession. Applying the *first in time, first in right* principle to this situation reduces the filing to the evidentiary means of proving priority, rather than a determinate device assuring the secured creditor's interest. This means that, after all, a filing creditor must check whether anyone had ever acquired an interest in the same asset before the filing of its security interest.

It is strange that PTMAR failed to provide a definite solution to the problem identified before the reform. But the problem may not remain if the judges, on a case-by-case basis, succeed in creating an appropriate balance between the interests of the *bona fide* purchaser and the interests of the creditor on file. A possible solution to the "lack of public notice" is for the courts to hold that a failure to check a filing (with regard to a movable), before its acquisition, constitutes negligence. Similarly, if the courts adopt a rule of evidence that makes it difficult to prove the fictitious transfer of possession, the cost of checking before the filing will be reduced. There is a good chance for such developments because Japanese case law is flexible and equitable, as contrasted with the formalism of law-making.⁵⁰

50. Although Japan belongs to the Civil Law system, the courts in Japan have played an active role in developing the law case decisions. Within a few years of the enactment of the Products Liability Law in 1996, courts decided a few cases in favor of consumers by applying the new law. See LUKE NOTTAGE, *PRODUCT SAFETY AND LIABILITY LAW IN JAPAN* 161-170, 206-208 (2004).

III. A CHANGE IN JAPANESE BANKING PRACTICES

This section makes a quick assessment of how PTMAR has affected the practice in Japan within a rather brief time since its enactment. First, it will discuss how well the filing under PTMAR has been used. Then it will mention the impact of PTMAR on related professions. Finally, it will consider a more theoretical question of shift in thoughts, or whether the “old ideas” of the Japanese bankers have changed after the introduction of PTMAR.

A. Current Filings Made and Examples of Securities Used

Notwithstanding the legal problems mentioned above, PTMAR appears to have had some impact on banking practices. Within five months of its entry into force in October 2005, as many as 305 filings were made.⁵¹ The first reported case of financing that made use of the filing was the loan of 50 million yen (\$40,000) extended to a wholesaler of seaweed by Shoko Chukin Bank and a local bank, in the form of a syndicated loan.⁵² The secured asset was the stock of the seaweed, probably in bulk. It was a model project backed by the Ministry of Economy, Industry and Trade.⁵³ Since then, Shoko Chukin Bank, a former semi-official financial institution specializing in financing for small and medium enterprises (“SMEs”), that was privatized in October 2008, has successfully used PTMAR for more than a dozen financial arrangements secured by movables. The assets taken as security include bottles of wine as stock of a liquor wholesaler, vegetables in a farm (*komatsuna* or Japanese mustard spinach) and *kimonos* as stock of their manufacturer. The loan amounts, mostly syndicated loans, vary between 30 and

51. Toshiyuki Dote, *Genzai no Dōsan Jōto Tōki oyobi Saiken Jōto Tōki no Riyō narabini Kōgo no Dōkō* [The Present Situation and Future Prospects of the Use of the Assignment of Movables], 1770 KIN'YŪ HŌMU JIJŌ 42, 45 (2006).

52. A syndicated loan is a loan where two or more banks join together to lend to a single borrower on the basis of a single set of lending documents. See AGASHA MUGASHA, *THE LAW OF MULTI-BANK FINANCING: SYNDICATIONS & PARTICIPATIONS* 22 (1998).

53. News Release, The Shoko Chukin Bank, Current Assets One Mortgage Type Financing (May 26, 2005), http://www.shokochikin.co.jp/newsrelease/nl_abl.html.

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300 million yen.⁵⁴

B. Specialized Careers as a Result of PTMAR

It has been pointed out that the development of asset-based finance, particularly involving movables, requires professional people to facilitate the financing. In order to evaluate the asset to be used as security, banks may turn to a specialized appraiser. After extending a loan, the lender (“bank”) needs a field examiner for the monitoring of the secured assets on site. In case of default, a liquidator is necessary to realize as much value as possible from the secured assets. Since PTMAR’s enactment, companies specializing in these professional activities have commenced doing business in Japan.⁵⁵ Such professionals will increase in number as asset-based lending becomes more common. Furthermore, the Association of Asset-Based Lending of Japan was established in June 2007 with the aim of developing expertise in this type of lending, inspired by the Commercial Finance Association (“CFA”) in the United States.⁵⁶

A somewhat related issue is the policy of bank regulators. Effective February 2007, the Financial Services Agency explicitly mentioned movables as appropriate security as long as the secured assets are adequately managed and reasonably evaluated.⁵⁷ This policy change is in accordance with the Basel Accord II.⁵⁸

54. See THE SHOKO CHUKIN BANK, 2007 ANNUAL REPORT 18–20 (2007).

55. The pioneer was the Truva Group with subsidiaries in appraisal and monitoring of the secured assets as well as consulting in asset based lending. See Truva.com, Truva History, <http://www.truva-gh.com/outline/outline05.html> (last visited Apr. 12, 2009).

56. Press Release, Ministry of Economy, Trade and Industry, Today’s News Topics (June 29, 2007), <http://www.meti.go.jp/english/newtopics/data/n070629e.html>.

57. FINANCIAL SERVICES AGENCY, INSPECTION MANUAL FOR DEPOSIT-TAKING INSTITUTIONS 132 (2007), http://www.fsa.go.jp/en/refer/manual/yokin_e/y-all.pdf.

58. See BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK, COMPREHENSIVE VERSION, BANK FOR INT’L SETTLEMENTS paras. 289, 509–24 (June 2006), <http://www.bis.org/publ/bcbs128.pdf>.

C. Will Business Practices in Japan Change under PTMAR?

When we consider the theoretical impact of PTMAR on Japanese banking practice, it is useful to compare it with the current practice in the United States. In the United States, the lender takes almost all of the assets of the debtor: from raw materials, to the stocks, to the receivables and then to the proceeds. Such a practice can be explained by the agency theory of the benefits of the secured transaction law: If all the assets are subject to the security interest of the first creditor, the creditor can be sure that the debtor will not opportunistically increase its risk afterwards by taking a second loan. If the lenders in Japan worry about such opportunistic debtor behavior, and wish to establish a similar practice of creating security interests in all of the debtor's assets, PTMAR has answered this issue.

Prior to PTMAR, the lender was able to acquire a mortgage on real estate under the Civil Code and take the receivables by transfer by way of security and file its security interest according to the Law on Special Rules to the Civil Code Concerning the Perfection of the Assignment of Receivables (renamed as PTMAR). The movable asset was the only type of asset in which a security interest could not be created. Now the lender can take the debtor's movable assets by transfer by way of security and file its security interest under PTMAR. Therefore, the lender can, if it so wishes, take all the assets of the debtor as the security for its loan, as would a lender in the United States, by filing its security interest in "all the assets of the debtor."

There seems to be inconsistent evidence about whether the practice under PTMAR has in fact changed general financing practices. The bank continues to count on the value of the stock measured through its sales, even in reported cases of filing under PTMAR. This is an old idea about secured transactions in Japan, carried over from the practice of relying on mortgages on the land owned by the debtor. But changes are appearing in the arguments about the appraisal of movables as security and filed under PTMAR. To be more precise, whether the appraisal should be made in accordance with the liquidation value or the cash flow expected from the business of the debtor has become an issue. The latter idea of looking at the cash flow may reflect changes in the perceived role of the security: How the security affects the behavior of the debtor is now explicitly being considered. Thus, it is yet to be seen whether PTMAR triggers a

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shift in the minds of Japanese lenders about their approach toward taking securities in the course of lending.

IV. THE REFORM'S EFFECT ON PRIVATE INTERNATIONAL LAW

This section will discuss the rules for determining the law applicable to security interests with one or more foreign factors. These rules are generally referred to as private international law rules or conflict of laws rules. PTMAR will apply to secured transactions only to the extent that the conflict of laws rules point to the laws of Japan.

A. *The Law Applicable to Security Rights*

General conflict of laws rules are codified in the *Act on the General Rules of Application of Laws* (“Application of Laws Act”).⁵⁹ Since PTMAR has no conflict of laws provision, courts primarily rely upon the Application of Laws Act to decide conflict of law issues that arise from security interests. Article 13 in pertinent parts provides that rights in rem to movables, to immovables, and to any other rights requiring filing, shall be governed by the law of the place where the property is situated (*lex rei sitae*).⁶⁰ Therefore, the security interests in movables are governed by the law of the place where the movable is situated (*lex rei sitae*).⁶¹

59. Hō no Tekiyō ni Kansuru Tsūsokuhō [The Act on the General Rules of Application of Laws], Law No. 78 of 2007, *translated in* Kent Anderson & Yasuhiro Okuda, *Translation of Japan's Private International Law: Act on the General Rules of Application of Laws [Hō no Tekiyō ni Kansuru Tsūsokuhō], Law No. 10 of 1898 (as newly titled and amended 21 June 2006)*, 8 ASIAN-PACIFIC L. & POL'Y J. 138 (2006); *see* Masato Dogauchi *et al.*, *Act on General Rules for Application of Laws (The New Japanese Code of Private International Law)*, 50 JAPANESE ANNUAL OF INT'L L. 87 (2008).

60. Hō no Tekiyō ni Kansuru Tsūsokuhō [Act on the General Rules of Application of Laws], Law No. 10 of 1898, art. 13, *translated in* 8 ASIAN-PAC. L. & POL'Y J. 138, 148 (2006).

61. The applicable law to a security right in a claim is construed to be the law governing the claim. *See* Aki Kitazawa, *Law Applicable to the Assignment of Receivables in Japan (Nihon ni okeru saiken Joto no junkyō-ho)*, in Basedow *et al.* eds., *supra* note 4, at 137–39, 146–47; Aki Kitazawa, *New Private International Law of Japan: Assignment of Receivables and Set-Off*, 50 JAPANESE ANNUAL OF INT'L L. 77, 84–85 (2008). *Sakurai v. Bangkok Bank Ltd.*, 32 (3) Minshu 616 (Supreme Court of Japan, Apr. 20, 1978). For an English translation of this case, *see* <http://www.tomeika.jur.kyushu-u.ac.jp> (last visited Apr. 6, 2009); *see also* Yoshiaki Nomura, *The Law Applicable to the*

In light of the foregoing, with respect to the movables situated in Japan, a Japanese court will hold that Japanese law will govern the effects of the security interests on third parties (“third party effectiveness”). Third party effectiveness under Japanese law includes the questions such as perfection, effect of perfection or non-perfection of a security interest. Therefore, the court will conclude that the filing under PTMAR of movable securities will be effective against third parties. But if these movables are situated in jurisdictions other than Japan, Japanese courts will hold that the law of the jurisdiction where the movables are situated will govern third party effectiveness. It is likely that, under the applicable foreign law, the courts will not recognize the third party effectiveness granted by the filing under the PTMAR.

As a result, if properties are situated in more than one jurisdiction, parties may be burdened to refer to the law of every jurisdiction in which each property is located, and to satisfy third party effectiveness requirements separately for each of them. For example, a debtor located in Japan has inventory in warehouses in Japan, Korea, China, and the United States. If this debtor has borrowed money secured by a security interest in the debtor’s inventory, then the lender would have to fulfill third party effectiveness requirements for each jurisdiction where the debtor has the inventory. This is because third party effectiveness is governed by the law of the jurisdiction in which the property (the inventory) is situated.⁶² Furthermore, because property can move from one jurisdiction to another, it often becomes impracticable to investigate the law of the location of each property.⁶³

Assignment of Receivables: Japanese Conflict of Law of Law Rules in the Age of Securitization, 41 JAPANESE ANN. OF INT’L L. 44, 55 (1998) (describing the *Horei*’s governance of conflict of law issues, and proposing that using the law of where the assignor is located is a better method).

62. See Neil B. Cohen & Edwin E. Smith, *International Secured Transactions and Revised U.C.C. Article 9*, 74 CHI.-KENT. L. REV. 1191, 1207 (1999).

63. See WHITE & SUMMERS, *supra* note 21, at 194.

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B. The Reason to Choose the Lex Rei Sitae

The Application of Laws Act was amended in 2006, and no change was made to the *lex rei sitae* rule.⁶⁴ In the amendment process of the Application of Laws Act, a concern was expressed that the *lex rei sitae* would hamper the efficiency of taking security in movables, because, in the event that movables are situated in more than one jurisdiction, parties would have to refer to the law of each jurisdiction with regard to third-party effectiveness. Nevertheless, the drafters of the amendment decided not to change the rule. Rights *in rem* to movables remain governed by the *lex rei sitae*. One of the main reasons is that the drafters believed that Japanese practitioners involved in finance had no need for the bulk security of movables in an international situation. Another reason is that the *lex rei sitae* governing rights *in rem* to movables does not appear to have caused any problems in practice.

In fact, practitioners from one of the largest banking groups in Japan raised concerns about the application of the law of the debtor's jurisdiction to third party effectiveness. A secured party may be uncertain that the security right can be enforced in the country where the collateral is situated. This concern exists even if a secured party has fulfilled the requirements for third party effectiveness under the law of the debtor's jurisdiction.⁶⁵ This concern seems to derive mainly from the "old ideas," as mentioned above in Part IV, that the appraisal of the security right should be based on the liquidation value. If the appraisal of a security right is based on the cash flow of the collateral, the practitioners may prefer the law of the debtor's location to the *lex rei sitae*.

64. On the other hand, the rules for contracts and torts in the former Application of Laws Act (*Horei*) were largely amended. For the details of the amendment to the conflict-of-laws rules for contracts, see Yoshiaki Nomura, *Harmonization and Diversification of Contract Conflicts*, 51 JAPAN Y.B. INT'L L. 341 (2009). For an English translation of the *Horei*, see Kent Anderson & Yasuhiro Okuda, *Horei, Act on the Application of Laws: Law No. 10 of 1898*, 3 ASIAN-PAC. L. & POL'Y J. 230 (2002).

65. See Cohen, *supra* note 62, at 1230.

*C. The Exception to Article 13: The Problems of the Lex Rei
Sitae*

Japanese conflict of laws rules, including a rule concerning transfer by way of security, derive not only from statutory law, but also from case law and academic theory based on the principles of justice and reason. Though the Application of Laws Act provides no special rule as to the *lex rei sitae*, it is reasonable that the exception to the *lex rei sitae* rule may be permitted, when there is a place which is more closely connected to the problem in question than the place where the property is situated. As to security interests in bulk goods which are held worldwide, the secured party has to satisfy requirements separately for each property. In this case, the potential creditor owes the same burden as the secured creditor, and he or she also must refer to each law of each movable's jurisdiction for an investigation into the financial status of the debtor. As for the security interests in movables, if the movable can be used universally, this may cause difficulty in identifying the law of the jurisdiction where the movable is located.

Under the UCC, however, the perfection of nonpossessory security interests is governed by the law of the debtor's location.⁶⁶ This debtor-location rule has the advantage of subjecting the security interests to a solo regime instead of having the situs of each movable determined separately. Furthermore, the debtor who is a business entity such as a corporation⁶⁷ may move less frequently than the movable, making the advantage of the debtor-location rule all the more clear. It is suggested that a Japanese court will hold that third party effectiveness relating to transfer by way of security is more closely connected with the place where the debtor (the transferor) is located than the place where the property is situated.

66. U.C.C. § 9-301 (2008). "While collateral is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a possessory security interest in that collateral." *Id.* § 9-301(2).

67. As described in Part III, only where the transferor is a corporation is the secured transaction governed by PTMAR.

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CONCLUSION

PTMAR introduced a filing system for secured interests in movables which is apparently similar to the filing system under UCC Article 9. It may have been inspired by the success of the latter, not only in practice in the United States, but also as a model for the law of secured transactions in many jurisdictions in the world. A closer examination, however, reveals more differences than similarities between the two laws. The formalistically defined scope of application, the requirement of the identification of the secured asset, the lack of rules on the effects of the substantive rights of the secured creditor and the rules on priority are largely left unchanged. This all shows that UCC Article 9, as a source of inspiration, has been adapted to the context of the Japanese law of secured transactions.

Judging from the rather conservative features of PTMAR, a theoretical shift about why the security is necessary for the creditor does not appear to have taken place in the minds of lawyers. Nor is it apparent with regard to bankers, as the appraisal practice still attaches great importance to the liquidation value of the secured asset, rather than the cash flow produced by the debtor. Old ideas die hard. Pieces of legislation cannot easily change that.

Still, the reform could have impacts in the long run. The practice in banking has already responded to PTMAR and devised finance schemes secured by movables, which were not imaginable before the reform. Some of the issues left unchanged by PTMAR, including the choice-of-law issues when the transaction involves cross-border elements, will be resolved on a case-by-case basis as the courts face these issues in the years to come. This may prove to be a better process for developing the appropriate rules. The lesson learned is that statutory reform, conspicuous though it may be, should not be viewed in isolation. The true reform of law takes place gradually, with changes in practice preceding or following the former.⁶⁸

68. See Luke Nottage, *Perspectives and Approaches: A Framework for Comparing Japanese Corporate Governance*, in CORPORATE GOVERNANCE IN THE 21ST CENTURY: JAPAN'S GRADUAL TRANSFORMATION 38-41 (Luke Nottage, Leon Wolff & Kent Anderson eds., 2009) (observing a "gradual transformation" in Japanese corporate governance).

