The Legal Environment of International Finance: Thinking about Fundamentals

Merritt B. Fox
University of Michigan Law School

Follow this and additional works at: https://repository.law.umich.edu/mjil

Part of the Banking and Finance Law Commons, and the International Trade Law Commons

Recommended Citation
Available at: https://repository.law.umich.edu/mjil/vol17/iss3/7
THE LEGAL ENVIRONMENT OF INTERNATIONAL FINANCE: THINKING ABOUT FUNDAMENTALS


Reviewed by Merritt B. Fox*

The huge increase in cross border capital flows over the last two decades has profoundly important implications for society in general and the law in particular. These flows give rise to a set of legal problems that are sufficiently distinct and coherent to constitute a legal field of their own. Confirming this observation is the development of a specialized legal practice whose members spend the bulk of their time working on such transactions. Nevertheless, a law school course in international finance is a rarity, even at the schools that train most of the students who ultimately join this practice.

The arrival of the first casebook in the area is thus a signal event, particularly so because of its high quality. International Finance: Transactions, Policy, and Regulation is bound to encourage the offering of courses in the area and influence their content. In doing so, the book is likely to affect how lawyers practice and hence the development of the law itself. Its publication thus invites an attempt to identify the fundamental features of international finance as a subject of legal inquiry.

Understanding the legal environment in which cross border capital flows occur requires three types of knowledge. The first, and main focus of the Scott and Wellons book, concerns the institutions of international finance: its organizations, practices, products, and regulatory backdrop. The second concerns the political economy of cross border capital flows: why do they take place, what impediments prevent an even greater volume, why do they take their different forms, what are their overall welfare effects, and who is helped and who is hurt by them? The third concerns the rules that directly structure the behavior of parties to these transactions and determine their obligations, rights, and remedies.

* Professor of Law, University of Michigan Law School. Ph.D. (Economics), Yale University (1980); J.D., Yale University (1971); B.A., Yale University (1968). Financial support for this research was provided by the Cook Fund of the University of Michigan Law School.
I. THE INSTITUTIONS OF INTERNATIONAL FINANCE

A reader of this book, unless already deeply engaged in the business of international finance, is certain to become far more sophisticated about its institutions. The authors cover an impressive array of topics using clear, remarkably up-to-date materials, most of which are easily accessible to readers without a technical background.

The authors start with the offering and trading of foreign securities within the United States. Readers are exposed to the different markets existing in the United States and their regulatory frameworks. In addition to the public markets, the authors describe the Rule 144A market, in which securities of foreign issuers may, without registration, be offered and sold to qualified institutional buyers. They also introduce the workings of American Depositary Receipts (ADRs), whereby a U.S. investor can hold a security which represents a share of a foreign issuer but which is publicly traded in the United States, transferable in the U.S. on the books of a U.S. bank, and pays dividends in U.S. dollars.

A number of other topics involving securities are covered as well. The authors describe the structure and regulation of European and Japanese securities markets and the growing importance of competition among the securities markets of the world. Included in this description is a provocative discussion of the possible structural causes of the Japanese stock market crash in the early 1990s and their relation to the country's continuing economic problems. There are careful treatments, both at a national and transnational level, of clearance and settlement mechanisms and of capital adequacy requirements for securities firms. In each case, the discussion is accompanied by a consideration of how the matter affects the risks of transnational securities transactions. The authors also provide descriptions of the markets and regulatory environments for several other kinds of transnationally tradable assets, including Eurobonds, global bonds, the securities of asset securitizations, the securities of privatizing enterprises in emerging market countries, and options and futures. The privatizing enterprises discussion is neatly built on a case study of the privatization of Mexico's Telemex and includes a discussion of the December 1994 peso crisis. The options and futures discussion includes a brief analysis of the Barings collapse and its regulatory lessons.

The book contains extensive materials on exchange rate systems, foreign exchange markets, and the attempt to create a single European currency. There is a particularly good discussion on the costs and benefits of a single currency and of its large political ramifications. The currency exchange materials are presented early in the book, thereby
permitting the later discussions of Eurodollar loans, derivatives and swaps to assume a basic understanding of the relationships among inflation rates, exchange rates, and interest rates.

Finally, the book contains materials on international banking and on payments systems. The authors describe the U.S., European, and Japanese banking systems, with a special emphasis on the regulation of foreign banks and the overseas operations of domestic banks. The Japanese discussion includes an interesting consideration of regulatory reforms in response to the country's early 1990s financial crisis and the continuing "bad loan" problem. There is an intelligent analysis of the problems in judging a bank's capital adequacy in relation to the risks of its loan portfolio and the contributions of the Basle Accord in establishing minimum regulatory standards in this area. The extensive discussion of payments systems — the process by which value is transferred from one party to another through transfers of claims on banks — would help even experienced practitioners better understand this arcane but important element of risk in many international transactions.

II. THE POLITICAL ECONOMY OF CROSS BORDER CAPITAL FLOWS

Scott and Wellons do not attempt to lay down, in any kind of explicit fashion, a theoretical foundation concerning the phenomenon under study. Bits and pieces are provided along the way through the book, but it is worth considering briefly what a more comprehensive treatment would look like and its potential rewards.

According to neoclassical economic theory, cross border capital flows occur for two reasons. The first concerns differences between nations in their amounts of domestically generated savings relative to the real investment opportunities available within their borders. Imagine this in the context of a world with two countries, A, a country with more savings relative to its domestic real investment opportunities and B, a country with less savings relative to its domestic opportunities. In the absence of cross border capital flows, these differences will mean that the marginal real investment project in A will have a lower expected rate of return than that of the marginal real investment project in B. If cross border capital flows are possible, persons with savings in A will have incentives to invest them, directly or indirectly, in projects in B. More projects will be implemented in B and fewer projects will be implemented in A. Global economic welfare will be enhanced since the projects that would otherwise have been implemented in A have a lower expected return than the ones the flows permit to be implemented in B.

Who is hurt and who is helped? Notwithstanding the global gain, the transfer is harmful to labor in A since a smaller capital stock will
reduce labor's marginal productivity and hence wages (a point made salient by Patrick Buchanan in this year's presidential campaign). For parallel reasons, it will be harmful to savers in \( B \). The gainers are savers in \( A \) and labor in \( B \). In each country, the gains of the gainers exceed the losses of losers since each country is taking advantage of the difference between its domestic ratio of wages to return on capital and the ratio of wages to return on capital abroad by, in essence, importing the factor that is relatively cheaper abroad.

The second reason for cross border capital flows suggested by neoclassical theory is that they permit welfare enhancing reallocations of risk. The most important aspect of this is the potential it creates for greater investor diversification. An investor who takes advantage of this potential significantly reduces the amount of risk she incurs in connection with a portfolio having any given expected rate of return. She can thereby improve the tradeoff she faces between risk and return. This happens because the addition of foreign investments to the set of opportunities in which she can invest results in the opportunities having less in common with each other than before. This reduces the "systematic" component of the risk associated with each available opportunity. The remainder — each opportunity's "unsystematic" risk component — can be diversified away. So the investor can construct a portfolio with the same expected return as before, but with less risk.

This risk allocation reason for cross border capital flows has some interesting implications. For instance, it suggests that the flows will go both ways. This is important politically because it will lead different countries to have more similar perspectives: each will have investors that are hostage to the policies of the others. Also, for the flows leaving countries with a relative abundance of savings to ones with a relative shortage of savings, a smaller portion will be in the form of direct investment, and a larger portion will be in the form of more easily diversified publicly traded securities sold to portfolio investors.

The risk-allocation reason for cross border investing also presents a puzzle: why isn't there more of it? U.S. investors, including professionally managed institutional ones, are still far less diversified internationally than finance theory suggests they ought to be. As a result, they

---

1. The world, of course, is more complicated than this simple model. For reasons discussed below, there are capital flows going in both directions. The reaction abroad to U.S. policies that reduce capital outflows would probably result in reduced capital inflows as well. If the reduction in inflows were sufficiently great, labor would actually be worse off than if the policies reducing outflows had not been initiated.

2. Investors' "home market bias," the tendency to underdiversify internationally, has received considerable attention by academics and practitioners. See, e.g., Ian Cooper & Evi
appear to be enduring either substantially less returns or substantially more risk than they could be. The explanation may in part involve a sense on the part of most investors that they are likely to do better investing in issuers about which they have more information despite the admonitions of efficient market hypothesis adherents to the contrary.\(^3\)

This sense may or may not be an accurate perception of reality today, but in either case it will decline with increasingly global diffusion of information. Other impediments to transnational investing — the cost and difficulty of effecting transactions in foreign markets\(^4\) and the risks associated with inadequate securities firm capital requirements, clearance and settlement systems, and uncoverable exchange rate exposure — are likely to decline over time as well. For example, Scott and Wellons describe in detail current national and multinational efforts to diminish these risks.\(^5\)

---

3. The efficient market hypothesis suggests that an investor is not at any disadvantage trading in a security for which he does not know publicly available information relating to its value because such information is already reflected in the price at which he buys or sells. This would suggest that the fact that he knows less about foreign issuers than about domestic ones should not deter him from trading in foreign issuer securities and that for any given number of stocks, the way to achieve the portfolio with the best risk/return tradeoff is to choose randomly from among all the world's issuers.

The absence of anything approaching this kind of international diversification is explained in part by the fact that many investors, whether they should, choose their portfolios on the basis of their own beliefs, not randomly. Those beliefs in turn are based on specialized information not possessed by all participants in the market. Such investors are likely to believe that they will do better by concentrating their buying and selling in equities of issuers about which they and their advisers start with natural information advantages. The futures of most issuers are determined more by forces within the borders of their own nation than by forces occurring outside. As I have developed in more detail elsewhere, residents of a given nation have advantages over foreigners in gaining specialized information about events occurring inside their nations. Merritt B. Fox, Securities Disclosure in a Globalizing Market: Who Should Regulate Whom, 10–11 (University of Michigan Law & Economics Working Paper Series No. 12, 1996) (on file with Michigan Journal of International Law).

Other commentators share the view that home bias is primarily explained by the local nature of much of the information to which people have access. Martin S. Feldstein, Domestic Saving and International Capital Movements in the Long Run and the Short Run, 21 EUR. ECON. REV. 129, 148 (1983); Robert E. Lucas, Jr., Interest Rates and Currency Prices in a Two-Country World, 10 J. MONETARY ECON. 335, 357 (1982).


5. Id. at 264–90, 391–427, 836–54.
Neoclassical theory assumes a world in which investment opportunities in each country are a given, there is no money, and all resources including labor are fully employed. Powerful insights emerge from the resulting model, but relaxing one or more of these assumptions can suggest additional reasons why cross border capital flows occur, as well as why national governments sometimes want to limit them. For example, a country's investment opportunities are not necessarily a given. In some cases, they may exist only if some needed element is provided from abroad. This might be managerial expertise, technology, marketing channels, brand recognition, or other parts of what is most efficiently structured as an integrated enterprise. In such a situation, depending on the particular patterns of information asymmetries and moral hazard problems, the needed foreign element may not be available unless accompanied by capital from the same source. If so, there must be a cross border capital flow, this time in the form of direct investment, whereby a corporation in one country establishes facilities in another. This reason, too, will lead to two-way flows, for example, U.S. auto companies establishing operations in Europe and European auto companies establishing operations here. The introduction of money and multiple currencies into the model suggests yet another reason, related to the interplay of interest rates and expectations concerning future exchange rates, why investors would want to engage in cross border capital transfers. It also suggests why government officials might want to limit these flows in furtherance of their monetary or exchange rate goals even when such regulations might inhibit the cross border flows motivated by welfare-enhancing investor desires to reallocate risk or capital for real investment. The introduction of possible labor unemployment into the model can, in a country politically unable to use macroeconomic tools to stimulate its economy, undermine neoclassical theory's conclusion that capital outflows to higher return projects abroad produce a net gain to the residents of the capital exporting country.

Knowledge of this larger context in which the institutions of international finance operate is helpful in a number of ways to lawyers, investment bankers, commercial bankers, corporate executives, government officials, and scholars. First, this knowledge makes work in international finance more professionally satisfying because it illuminates the positive social functions served by many of the transactions with which such persons are likely to be involved. On a more practical level, the same kind of calculus helps identify potentially value creating transactions — ones that leave both parties better off — the impediments to which can be overcome by imaginative, new kinds of structuring. An example would be a packaging plan for a previously unsecuritized asset that
would generate a combined cash flow with sufficiently predictable characteristics to permit their securitization and the offering of the resulting securities internationally. By providing a new opportunity for greater diversification, this scheme will lower the cost of financing the assets involved—say, home mortgages—and improve investor welfare at the same time. For an advocate, the calculus provides a source of effective arguments in cases where it shows a public gain from a legal or other governmental decision desired by a client. For judges and legislative and administrative officials, it provides a basis for evaluating arguments that advocates put forward. For the counselor, the calculus helps predict the reactions of governmental agents to a client’s proposed actions.

Knowledge of this larger context also helps persons in all of these roles identify trends and calculate who will be helped by them and who will be hurt. One example concerns the large gains that can still be obtained from further international diversification and the probable rapid decline in the impediments that have prevented greater diversification so far. These factors suggest that we will see a massive increase in cross border portfolio investment in the next decade or so. One result is likely to be a great increase in transnational competition among securities exchanges. To the extent that countries determine whether to impose their disclosure rules on issuers based on whether the issuers’ securities are offered or traded within their borders, this increased competition will create political pressures that might well lead to a disclosure rule race-to-the-bottom. Another result is the likelihood that most major corporations, whatever their nationality, will, through transnational portfolio investment, eventually become majority foreign owned. This has interesting corporate governance implications. For any given corporation, shareholder expectations concerning what constitutes good management

7. U.S. investors currently hold approximately $7 trillion of the total world capitalization of $17 trillion. James L. Cochrane et al., Foreign Equities and U.S. Investors: Breaking Down the Barriers Separating Supply and Demand 1 (New York Stock Exchange Working Paper No. 95-04, 1995) (on file with Michigan Journal of International Law). Some commentators predict that U.S. investors will double the foreign component of their equity portfolios from 5% to around 10% within the next few years; this translates into $350 billion moving into foreign equities. Id.
are likely to change. Also, the shift in ownership pattern is likely to enliven transnational competition in corporate chartering.

Another example of how this knowledge can help predict trends concerns the mix of methods used to channel capital to promising projects in developing countries. Traditionally, much of this was in the form of direct investment by North American and European corporations. Developing countries, however, found it increasingly offensive that decisions having important impacts on their economies were being made from abroad. With the glut of petrodollars starting in mid-1970s, an alternative form of capital transfer was developed, the syndicated Eurodollar loan. It was popular with developing countries in part because it appeared not to have the foreign control problems associated with direct investment. What should have been apparent at the time became obvious with hindsight: funding promising projects in developing countries with long term loans having rates that float corresponding with changes in short term money markets involves an extraordinarily inefficient allocation of risk. The developing country, the party least able to diversify away risk and withstand what is left, ended up with the riskiest position: a levered claim on the project’s residual cash flow. The problem was aggravated by a tendency in the next decade for interest rates to be inversely correlated with that cash flow. Adding insult to injury, the control gains turned out to be illusory since most borrowers became unable to meet their obligations. The resulting workouts gave foreigners, such as International Monetary Fund officials, considerable power over local economic policy.

The obvious alternative is to fund promising developing country projects through transnational equity sales to portfolio investors. This

9. As more investors from country A begin to invest in country B companies, the investors from country A — who have had most of their prior experience with a corporate law regime different from B’s — will carry their expectations with them and affect the investor relations climate for firms in country B.

10. As a corporation’s shareholdings become less dominated by shareholders from its home country, there may be greater acceptance of a change to a foreign country of incorporation. Whether competition in corporate chartering among states within the United States is good or bad has been the subject of considerable debate. See Bebchuk, supra note 8; William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663 (1974); Peter Dodd & Richard Leftwich, The Market for Corporate Charters: “Unhealthy Competition” versus Federal Regulation, 53 J. BUS. 259 (1980); Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. ECON. & ORGANIZATION 225 (1985); Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. LEGAL STUD. 251 (1977).

11. See, e.g., ANDREAS F. LOWENFELD, INTERNATIONAL PRIVATE INVESTMENT 81–185 (1982) (detailing the history of foreign private investment in Chile’s copper industry since the early 1900s); HENRY J. STEINER ET AL., TRANSNATIONAL LEGAL PROBLEMS, 455–66 (1994) (describing Mexican expropriations of foreign owned agrarian and oil properties between 1915 and 1940).
form of cross border capital flow combines direct investment's superior risk allocation with Eurodollar lending's supposed freedom from foreign control. While the early 1990s speculative enthusiasm among U.S. investors for emerging market equities has dampened somewhat, impediments to this sort of investment should decline. We can reasonably expect over time the development of credible corporate governance structures for the issuers of this equity, fair and efficient markets for these equities to trade in, and more effective national disclosure regimes. With these developments, there should be a large growth in capital raised in this fashion.

III. RULES DIRECTLY STRUCTURING INTERNATIONAL FINANCE TRANSACTIONS.

The third kind of knowledge needed to understand the legal environment in which cross border capital flows occur concerns the rules that directly structure the behavior of parties to these capital flows and determine their obligations, rights, and remedies under any given set of terms. Again, Scott and Wellons give this relatively little attention. Indicatively, while there is a large number of questions scattered through the book asking students to give advice to policymakers, there are comparatively few questions asking students to give advice to persons actually engaged in cross border transactions.

The distinctive feature about the rules that govern the behavior of parties to cross border financial transactions is the absence of a single, unitary legal system. Consider three examples of the kinds of problems that arise as a result. The first example involves a German firm offering a new issue of its stock. The offering is handled by some German investment banks who are only contacting investors residing in Europe. During a trip to New York, however, the chief executive makes some enthusiastic statements about the firm's future to a room full of reporters from the world's business press. The statements make their way into the Wall Street Journal and, predictably, a certain number of Americans place orders with brokers in Germany for the firm's shares. Should the issue be registered under the Securities Exchange Act of 1933 providing

12. A number of institutional changes, assisted by experts from the developed capitalist countries, are underway in emerging market countries. See, e.g., Robert Rice, Business and the Law: Clearing the Way for Capital — A Look at a Model Law to Provide the Basis for Workable Secured Lending Regimes in Eastern Europe, FIN. TIMES, June 14, 1994, at 20; Emily Barker, Starting from Scratch, AM. LAW., June 1994, at 42 (describing efforts of the European Bank for Reconstruction and Development to draft laws dealing with security issues in Eastern Europe).
for disclosure in connection with public offerings? If the answer is yes, would this result have been avoided if the chief executive had restrained himself and not made the statement until he was in front of a similar gathering after his return to Germany even though the same Wall Street Journal article would have likely resulted? Suppose that the 1933 Act registration is not necessary but after a year of secondary trading on the Frankfurt exchange and on the “pink sheets” in the United States, 3000 U.S. investors own 52% of the firm’s outstanding shares. Is the firm now required to start complying with the periodic disclosure requirements under the Securities Exchange Act of 1934 despite the fact that it has not engaged in any focused attempt to acquire U.S. investors? If it is, what are the consequences of failing to comply? These questions involve issues of jurisdiction to prescribe under international law as well as United States policy on extraterritorial application of its securities laws. They are too new to have generated significant case law, but analogies are available from the United States approaches to the question of statutory reach in the areas of criminal law, choice of law, antitrust law, and the antifraud provisions of securities law.\(^{13}\) Facility in dealing with these kinds of questions is important for an understanding of the legal environment of international finance since such questions come up in connection with a range of securities and banking activities.

The second example involves an Eastern European enterprise whose shareholders, after privatization, are mostly Western European and North American investors. The enterprise accumulates significant assets abroad in the form of bank accounts, inventory, and sales facilities. A backlash election in its home country puts in power a new communist government that seizes the enterprise’s assets in return for some subordinated bonds of questionable value. What are the rights of the Western shareholders? If their rights have been violated, where can they get a judgment? If they get one, how do they enforce it? Have any rights of the United States been violated? If so, are there any remedies available that could help the investors and how likely is it that the United States government will pursue them? These questions involve issues of the obligation to protect alien property and sovereign immunity under international law, treaty interpretation, the United States act of state doctrine relating to judicial deference to executive authority, and the U.S. law of federal jurisdiction. The possibility that such a scenario could in fact occur makes the answers important inputs in calculating

\(^{13}\) See generally STEINER ET AL., supra note 11, at 820–994 (describing the transnational reach of national legal systems).
the risks of investing in shares of newly privatized companies in developing and former communist countries.

The third example involves a Eurodollar loan to a similar enterprise in another Eastern European country. The loan is guaranteed by the government. The enterprise's product is the country's principal export and the market for it becomes severely depressed. The enterprise defaults and the government, citing a severe shortage of hard currency reserves, declares a moratorium on honoring its guarantee. Again, the enterprise has significant assets abroad. The same questions arise as in the second example, with the lenders substituting for the shareholders. The possibility that this scenario could take place again makes the answers important for calculating the risks of making the loan in the first place. Also, at the outset of such a transaction, lawyers representing the various parties would want to know how the terms of the documentation would affect the rights and remedies available to the lenders. The same bodies of law applicable to the question in the second example are implicated here. Assuming that properly drafted documentation does increase a lender's rights and remedies, there is also the question of whether that documentation will really improve the lender's position if the scenario does eventuate, given that the matter almost certainly will ultimately be resolved by negotiation, not litigation. The experience of lenders with differing documentation in the Eurodollar loan workouts in the 1980s would be relevant here.

CONCLUSION

A law, business, or public policy student entering the field of international finance will have a substantial advantage if she takes a course using the Scott and Wellons book. As a teacher in the area, I was delighted at its publication and intend to assign it to my own students. Most practitioners already working in the field will also find it useful reading since few of them know the range of institutional detail provided by these materials.

The book is insufficiently comprehensive, however, to become the kind of classic that defines a field. Nor, with this limited focus, lack of bibliography, and lack of index, is it likely to become a standard reference work. Nevertheless, it is more than just another casebook. Its clear and concise materials illuminate the often mysterious and arcane details of the institutions of international finance and will open up a world about which many, absent its publication, would have remained ignorant. A future edition with a broadened focus would make the book that much more influential.
EDUCATING LAWYERS FOR
THE GLOBAL ECONOMY


 Reviewed by John O. Haley*

A review of a casebook may seem unusual to some, but Law and Investment in Japan: Cases and Materials merits attention by almost any measure. The principal author, Yukio Yanagida, is an international lawyer of high standing and reputation. This book is the product of his design for a course and the accompanying set of teaching materials that he originally taught at Harvard in 1991. His aim was to introduce students to the variety of legal problems lawyers face everyday when advising clients involved with investment in Japan. Selecting a typical investment transaction—a cooperative venture between Japanese and U.S. companies for the manufacture and sale of an industrial product—as the “principal case,” Yanagida harnessed a set of documents based on actual transactions with readings that would enable students to familiarize themselves with the panoply of Japanese legal problems that lawyers representing both Japanese and non-Japanese clients would encounter. The experiment worked. Subsequently, he and four outstanding younger legal scholars—all Harvard graduates—rewrote and reedited the original materials into their present form.

The book was an instant success. Few, if any casebooks on foreign law have been adopted so quickly by so many. Within days after its publication, it was used as the principal text in courses on Japanese law at the universities of Chicago, George Washington, Harvard, the University of Washington, and Temple in Japan. Both teachers and their students were fulsome in their praise and rightly so.

Readers familiar with the published research of Dan Foote, Mark Ramseyer, and Hugh Scogin will appreciate the diversity of approaches

* Garvey, Schubert & Barer Professor of Law, Professor of International Studies, and Director, Asian Law Program, University of Washington. LL.M., University of Washington (1971); LL.B., Yale University (1969); A.B., Princeton University (1964).
and interests that combined to produce this volume. To their credit, however, whatever their differences, their collaboration results in a coherent presentation that exposes their students and other readers to the full range of legal aspects of foreign investment in Japan. Concise, well-written chapters cover every relevant field of law. The book begins with an introduction to the basic economic and political issues. It continues with separate chapters that provide an overview of the Japanese legal system with welcome emphasis on its civil law heritage, the Japanese business environment, administrative process, regulation of foreign investment, negotiating and drafting, corporate forms and company law, taxation, intellectual property, antitrust, and dispute resolution. An entire chapter is devoted to publicly traded corporations and the attendant issues of shareholder control and mergers and acquisitions, including a glimpse at the Pickens-Koito dispute. Each chapter relates to the principal case, but the authors have written and organized the material so that each chapter can be used as effectively without reference to the model transaction. Superb translations of a substantial corpus of code and statutory material are also included in an appendix.

One of the authors' most impressive achievements is their effective integration of readings from a wide variety of disciplines — especially those on Japan's industrial structure, corporate organization, and business practices — interposed with translated cases and other legal materials. For example, the book begins with an excerpt from a 1991 report prepared by A.T. Kearney, International, Inc. for the American Chamber of Commerce in Tokyo on the prospects and problems of foreign investment in Japan. Among the variety of factors that limit foreign investment in Japan today, the report duly notes the high cost of land, the difficulties in recruiting the most able Japanese employees, the seemingly impenetrable density of ongoing business relationships in Japan against the backdrop of past public policies, and formal barriers to foreign investment.1 Juxtaposed with this account are a 1967 Daily Yomiuri editorial on failing joint ventures and portions of a 1990 Harvard Business Review essay in which Robert B. Reich, the current secretary of labor, questions the distinction between foreign and domestically-owned corporations. The three pieces not only represent provocative perspectives on Japan's postwar experience with foreign investment, but succinctly introduce the reader to the range of questions that have surrounded the issue for two generations.

In the chapters that follow, the authors continue to give their readers a sense of the historical complexity of Japanese postwar legislation on antitrust, trade, and investment. Much of the legislation related to foreign trade and investment, like Japan’s foreign exchange and foreign trade controls, reflect the unintended uses of early postwar emergency legislation. Other statutes, like the new Administrative Procedure Act, are the result of carefully considered and, at times, fiercely negotiated choice. Those involved in drafting Japan’s antitrust law, for example, probably did not anticipate the use of Article 6 — designed to prevent Japanese firms from participating in international cartels — as a means, since 1968, of protecting Japanese licensees of foreign technology against overreaching foreign licensors. The presentation of these issues is faithful to the reality being depicted. No single pattern of creation or change is evident or advocated.

Not only do the authors thereby demonstrate the effectiveness of an interdisciplinary approach, they also substantiate the relevance of Japanese law to many of the most vexing issues of postwar Japanese economic and political change. Again with remarkable economy, the authors include in Chapter 6, entitled “Regulation of Foreign Investment,” carefully edited selections that trace the variety of postwar legal controls that were used through the mid-1960s to restrict or channel foreign investment. The authors discuss the staged liberalization of these controls from 1968 through 1973 and the 1979 reform (effective in 1980) of the 1949 Foreign Exchange and Foreign Trade Control Law and the 1950 Foreign Investment Law, the statutory pillars of these controls. More on the origins of these statutes could have been added. Nevertheless, read together with the chapters on “Intellectual Property Law” (Chapter 9) and “The Antimonopoly Act” (Chapter 10), these materials cover the Japanese legal rules that have been and continue to be the most important in regulating foreign investment and trade, and should be required reading for all students of Japan’s postwar political economy.

A fuller understanding of the legal aspects of foreign investment in Japan engendered here would, one hopes, allow for a more accurate and dispassionate discussion of Japan’s postwar economic “miracle.” The “principal case” is, in effect, a study of how Japanese officials resorted to emergency regulations leftover from the Occupation in response to initiatives by Japanese firms to gain access to foreign technology and by foreign firms to gain access to the Japanese market. From this vantage point, it becomes difficult to argue that Japan’s economic success was solely the result of prescient, proactive strategies, and planning by officials, given the reactive use of an assortment of legal controls to channel
foreign trade and investment transactions. The extent to which both market forces and government intervention (often driven more by the narrowest sort of paternalist protectionism than by a strategic plan with implementing legislation) coincided to produce what we now label an "industrial policy" is laid bare in the details presented here.

Law and Investment in Japan is best evaluated, however, from the perspective of past efforts to teach Japanese law in American law schools. As a casebook, it represents the culmination of two-and-a-half decades of effort and achievement as well as the promise and prospect of Japanese legal studies in the United States.

Writing twenty-five years ago, Charles Stevens gave three reasons for the study of Japanese law in American law schools. First, as a blend of European, American, and indigenous influences, the Japanese legal system provides an especially rich source for comparative study. Second, Japanese law reflects the dynamics of change in a developing legal order. Finally, the importance of Japan as a commercial center requires that an increasing number of American lawyers engaged in international practice be familiar with at least the basics of Japanese law and practice related to trade and investment. Echoes of Stevens’ plea for the study of Japanese law continue. The principal justifications remain both pedagogical and practical. Japanese law is worth studying, we are told, because of the comparative insights it offers as a hybrid system in which elements of a traditional East Asian system merge with those derived from European and even American models. In addition, the study of Japanese law provides valuable lessons as a possible model for other nations seeking to use law as a tool of economic and political transformation, or seeking to ameliorate the social and environmental consequences of industrial growth. Lastly, it prepares students for practice in an increasingly complex world economy.

In 1971, as Stevens noted, only two law schools in the United States (indeed, anywhere outside of Japan) — Columbia and the University of Washington — included courses on Japanese law as part of their regularly taught offerings. Much has changed since 1971. Courses on Japanese law are routinely taught today at over a dozen law schools in the United States and at least half as many law faculties in other English-speaking countries.

4. Stevens, supra note 2, at 665.
5. Law schools (and tenured or tenure-track faculty with Japanese language ability and established research interest) that offer or at least have the potential to offer courses on
The first regularly offered course and related teaching materials on Japanese law were developed at the University of Washington in the mid-1960s by Dan F. Henderson, the director of the Asian Law Program (founded in 1962 with substantial funding from the Ford Foundation). Although Henderson's two-volume historical study of conciliation in Tokugawa law, the first edition of the materials used for the introductory course in Japanese law tended to stress both the formal structure of the Japanese legal system and features that it shared with other European-derived systems. Reedited and refined in 1978 and 1988 to include additional historical material and fuller treatment of judicial, administrative, and criminal processes in contemporary Japan, these materials were

---

widely distributed as a two-volume set titled *Law and the Legal Process in Japan*.

In the early 1970s, Charles R. Stevens began teaching an introductory course on Japanese law at Columbia Law School and later Harvard. For use in this course, Stevens and Kazunobu Takahashi compiled a set of basic materials on Japanese law similar to those prepared by Henderson. More topical than the Henderson approach, Stevens and Takahashi focused on a series of controversial issues, such as the debate over the constitutionality of Japan's self-defense forces under Article 9 of the Japanese Constitution and the legality of the Yawata-Fuji steel industry merger under the Japanese Antimonopoly Law, to stimulate interest in their students in Japanese law. Although Ko-Yung Tung continued the course at Columbia and for a decade at NYU, the Stevens and Takahashi materials were unfortunately never published or widely distributed.

The first commercially published set of teaching materials for an introductory course on Japanese law was Hideo Tanaka's *The Japanese Legal System*, distributed by the University of Tokyo Press in 1976. This casebook was widely used in the United States and overseas, including the course Ko-Yung Tung taught at NYU. Like Yanagida, Tanaka initially compiled the materials for a course taught at Harvard Law School. In the early 1960s, Harvard offered one of the first courses on Japanese law taught by Rex Coleman, and sponsored the first major research effort with the support of David J. Cavers and Arthur T. von Mehren. The Japanese American Society for Legal Studies was founded at Harvard in 1964 and, with Coleman as the first editor, the publication of *Law in Japan: An Annual* began as a Harvard Law School endeavor. These initiatives were short-lived, however, and interest in developing an ongoing instructional and research program focusing on Japan nearly died. By the mid-1970s, however, with support from both the Mitsubishi Corporation and the Ford Foundation, as well as the initiative of Jerome A. Cohen, Harvard's East Asian Legal Studies Program commenced a major effort to revive instruction and research on Japanese law. Tanaka's book was its first significant contribution.

During the 1980s, teaching materials on Japanese law proliferated with increased number of courses on Japanese law offered outside of Japan. Like the Stevens and Takahashi approach, most materials were designed for introductory courses, and many stressed the exceptional features of the Japanese legal system. They too remained unpublished. These efforts included materials used by Michael K. Young at Columbia and the compilations of cases and readings by Malcolm Smith, first at Monash University in Australia and later with Akio Morishima at the
University of British Columbia and Melbourne University. Frank K. Upham similarly compiled materials for courses he taught both at Boston College and Harvard and which he teaches currently at New York University. One set of materials, written by Elliott J. Hahn and used by him in a course he taught at California Western and in Santa Clara's summer program in Japan, was later published as a text rather than as a compilation of selected readings. The most recent addition to this genre was the set of introductory materials, in digital format, compiled by Kenneth L. Port while visiting at Chicago-Kent, and which have recently become available from the Carolina Academic Press.

These were not, however, the only available courses or teaching materials. Law schools across the country taught a variety of courses and compiled related teaching materials on specific fields of Japanese law. At the University of Washington, for example, beginning in the mid-1960s, visiting Japanese scholars working with American specialists in their primary fields of expertise developed a series of comparative law courses in the most important areas of law for trans-Pacific practice. These included courses and teaching materials on transnational litigation by Dan Henderson and Yasuhiro Fujita; United States and Japanese sales and contract law by the late Warren Shattuck and Zentaro Kitagawa; comparative intellectual property law by Teruo Doi; United States and Japanese corporation law by Misao Tatsuta and Richard Kummert; Japanese administrative law originally by Yasuhiro Fujita; and Japanese antitrust law, which began as a project with Mitsuo Matsushita. Work on most of these materials continues in order to keep them up-to-date. Few have been distributed outside of the Asian Law Program, and only one has been published — those materials prepared for a course on United States and Japanese tax law compiled by Jack Huston, Griffith Way, and Toshio Miyatake. It was published in 1983 by Matthew Bender under the title *Japanese International Taxation*.

The widely acclaimed book on *Japanese Environmental Law* by Akio Morishima, Kōichirō Fujikura, and Julian Gresser, published by the M.I.T. Press in 1981, represented the second significant contribution by Harvard Law School's East Asian Legal Studies Program. However, due to the absence of a regularly taught course on the subject, *Japanese Environmental Law* became more of a reference than a set of teaching materials. Nonetheless, by presenting in great detail the Japanese legal responses to pollution, this work invited its readers to learn from the

---

Japanese experience. Japanese law thus became relevant for others seeking solutions to similar problems. As such, these materials represent the most welcome trend in the field of Japanese studies.

The unpublished materials on foreign investment in Japan compiled by Richard W. Rabinowitz for the course he taught at Harvard in 1988 remain the most extensive collection on the postwar application of Japan's Foreign Investment Law and Foreign Trade and Foreign Exchange Control Law. Over 2000 pages of translations of the relevant statutes and regulations, law firm memoranda, and selected articles and essays cover the critical postwar years from the late 1940s through the early 1980s. Having practiced law in Japan through most of this period, Rabinowitz brought to the subject a wealth of personal experience and insight.

By the end of the 1970s, with initial funding from the Japan-United States Friendship Commission and later an endowment from the Fuyo group of Japanese companies, the Japanese Legal Studies Center was established at Columbia under the direction of Michael Young. Like the University of Washington and Harvard, a series of courses and teaching materials in specific areas of law and practice was developed by visiting Japanese faculty, such as Tasuku Matsuo and Mitsuo Matsushita.

More specialized courses were also being taught by visiting Japanese faculty elsewhere. At the University of Pennsylvania, for example, former Japanese Fair Trade Commissioner Michiko Ariga developed and taught a course on Japanese competition law based on translations of major commission and court decisions, which were subsequently incorporated into the materials used by Mitsuo Matsushita at the University of Washington, Harvard, and Columbia.

By the end of the 1980s, many American scholars with Japanese language ability had begun to concentrate their research and teaching efforts on more specific areas for comparative study. At UCLA, Taimie Bryant expanded her early work on family court conciliation to encompass a wide variety of issues and problems related to family law and registration. Robert Leflar at Arkansas and Stephan Salzberg at the University of British Columbia had become North America's leading experts on the legal aspects of Japanese health care and medical practice. Percy Luney at Duke and North Carolina Central concentrated on constitutional and environmental law issues. Mark Ramseyer had introduced a "law and economic" perspective into the field. At the University of Washington, Dan Foote rapidly established himself as the leading U.S. specialist on Japanese criminal justice as well as labor law. Trade and investment issues, however, were rarely the principal focus. Georgetown's adjuncts and visiting faculty like Amy Porges, Jeff Lepon,
and Alex Seita were exceptional in their emphasis on trade issues. None of these scholars, however, developed publishable materials for wider use.

Attempts were made in the early 1980s by the principal American scholars in the field to develop more specialized materials that could be used in conjunction with comparative law and other courses without a Japanese focus as well as in an introductory course on Japan. Through the efforts of Arthur Rosett, UCLA provided a center for this activity by sponsoring a series of workshops on Japanese law. An unpublished exercise on Japanese corporation law by Mark Ramseyer was its principal achievement. At these workshops, those in the field shared syllabi, reading units, and teaching approaches, all of which led to a greater insight and awareness of materials that others had developed. However valuable the workshops were in other respects, this particular effort to develop teaching materials failed.

As a result, except for Columbia, Harvard, NYU, and the University of Washington — which, as established centers for research and instruction on Japanese law, have been able to offer an introductory course — American law students today rarely have any exposure to the variety of areas of Japanese law they are most likely to encounter in practice. Few introductory courses even attempt to teach law students about the diversity of real problems and legal issues encountered in everyday transnational commercial practice. Unless followed by more specialized courses in contract, competition, and corporation law, in tax and trade regulation, or in labor and licensing issues, such courses risk misleading students to a false sense of the tangential role of legal rules in most transactions involving Japan. Therefore, the publication of *Law and Investment in Japan* does more than merely fill a vacuum. It adds a corrective focus and direction.

As an object of comparative study, the Japanese legal system has been viewed almost exclusively in terms of its historical evolution, its reception of Western law, and the consequential tensions between law and culture. Despite the remarkable expansion of Japanese legal studies, few courses have fully satisfied Stevens’ prescription. As noted, more specialized offerings covering particular fields of Japanese law that relate directly to trade and investment are occasionally taught, but nearly all introductory courses on Japanese law have emphasized only one or two of Stevens’ triad of themes.

From the content of the typical first course on Japanese law, Japan’s legal system appears to be largely perceived, in the words of Lawrence Beer and Hidenori Tomatsu, as a “laboratory” to test the efficacy of legal rules, processes, and institutions derived from the West in a non-
Western society. Western language works by noted Japanese scholars, particularly Takeyoshi Kawashima's studies on Japanese "legal consciousness" and Yosiyuki Noda's *Introduction to Japanese Law*, tended to confirm this emphasis with a twist. How and why the Japanese tended to avoid the law became the central concern. Alternative dispute resolution (both formal and informal), administrative guidance, and other manifestations of governmental informality; the irrelevance of contract as a result of repeated deals; ongoing business relationships; and various patterns of intrafirm connectedness (or *keiretsu*) were presented as the characteristic features of the Japanese legal system. With few exceptions, the primary lesson seemed to be the irrelevance of law to most of the Japanese.

Japanese scholars writing in English were among the first to dispel this notion. Kyoto University Professor Zentaro Kitagawa's idea for a multi-volume treatise on Japanese law was the most ambitious effort. The most recent effort is University of London Professor Hiroshi Oda's single volume work entitled *Japanese Law*. These works were not, however, designed as teaching materials. They do little to shape the perceptions of those students exposed to Japanese law in the typical law school course. Also, by neglecting the social context within which legal rules and processes operate, such works simply assume law's relevance.

I should also mention the remarkable contributions made by an increasing number of German legal scholars. Because of the influence of German law in Japan, German jurists are better situated as comparativists than either Japanese or American scholars to pinpoint the distinctive features of the German derivatives found in Japan's legal system, and to describe how German legal rules and institutions have been transformed to adapt to the Japanese environment. The most recent studies stress these characteristics and their cultural context.

14. See, e.g., 5 *DAS JAPANISCHE IM JAPANISCHEN RECHT* (Heinrich Menkhaus ed., 1994); *DIE JAPANISIERUNG DES WESTLICHEN RECHTS* (Helmut Coing et al. eds., 1990); *GUNTRAM...*
More than any other American scholar, Mark Ramseyer has persistently argued against all accounts that emphasize the irrelevance of legal rules in Japan. He pushes toward an extreme view, however, in leaching out any distinctive feature of Japanese law. Characteristics that others highlight as pivotal are themselves revealed to be irrelevant under Ramseyer’s scrutiny. Whatever analytical merit such exercises may have, they tend to be overly antiseptic in treating the variety of cultural elements that enrich all national legal systems.

However, in *Law and Investment in Japan*, Ramseyer and his co-authors present all sides. Nearly all of the persistent conundra of the field are set out for the student to resolve. The concluding chapter, “Publicly Traded Corporations,” is particularly illustrative. The chapter begins with a discussion of the role of shareholders, introduces the reader to the role of sōkaiya, the gangster-shareholder, and concludes with the Koito-Pickens dispute and the interrelationship of legal rules and business practices in explaining the dearth of hostile corporate takeovers in Japan.

The issue of whether shareholders have control is introduced with an excerpt from Abegglen and Stalk’s *Kaisha, The Japanese Corporation* on the ouster of Mitsukoshi department store president Shigeru Okada in 1982. For Abegglen and Stalk, the incident is the exception that proves the rule that shareholders lack control. Yet, the event itself demonstrates that shareholders ultimately do have the legal means to exert control and do exercise that ability when those individuals who they have entrusted with managerial authority cease to perform effectively in their interest. The chapter continues with the question of why hostile takeovers have been so rare in Japan. Again, Abegglen has the first word. He argues that “in Japan the concept of The Company is different . . . .” Because employees are viewed as integral components, selling a company is akin to selling people. Following Abegglen’s excerpt is a more structural explanation of cross-shareholding, followed by Ramseyer’s rebuttal stressing the theoretical likelihood of buyouts. Two translated cases at
the end of this chapter expose the fallacy of any single or reductionist explanation. In *Shūwa K.K. v. K.K. Chūjitsuya*, the Tokyo District Court scuttled a cross-shareholding scheme to forestall a hostile takeover. In *Mizuno v. Ariyoshi*, the Tokyo High Court affirmed a district court decision invalidating a subsidiary's acquisition of its parent company's shares at a premium from a major shareholder who opposed a planned merger. The facts of these cases and their outcome support the conclusion that while all three explanations have merit, they must also take into account the legal rules that regulate both managerial and shareholder behavior.

*Law and Investment in Japan* indeed inundates the reader with law and context. The sheer volume of judicial decisions, statutory provisions, and descriptive material presented in relation to a business transaction should dispel any lingering doubt students may have as to whether legal rules count in Japan. The authors raise questions of "legal culture" and issues of law avoidance and informality, but they do so in context. By including materials, particularly judicial decisions, they enable the reader to appreciate the varied environment within which these issues arise and have significance, particularly for lawyers working within the legal system. As a result, the student is at least exposed to the fuller complexity of law in Japan and to the relationship of legal rules and processes to the shared values, habits, and expectations of a community.

One of the best illustrations of the effectiveness of this inclusive approach is Chapter 7, titled "Negotiating and Drafting Agreements." It begins with three American views on Japanese negotiating style, including a previously unpublished Columbia Law School lecture by E. Anthony Zaloom that explains why many of these practices, from the emphasis on consensus to the tendency to avoid risks, hinder negotiations with the Japanese and the effectiveness of outside American legal counsel. *A Japanese View of American Negotiators* is a superb piece in which an anonymous Japanese negotiator expresses amazement at American negotiating foibles. Duly noted are our tendencies to moralize, to dicker, and even, in the author's words, to argue among ourselves with "no shame about such embarrassing behavior." Thus, we as Americans

20. Judgment of July 3, 1989, Kōsai [High Court], 1188 Shōji Hōmu 36 (Japan), *translated in* *Yanagida* et al., *supra* note 1, at 526.
22. *Id.* at 220.
learn as much about Japanese approaches and values from their observations of us as the Japanese must learn about us based upon our views of them. Interwoven with these "cultural" threads are the relevant legal rules. The chapter includes a brief introduction to the rules on contract formation from the civil and commercial codes and a translation of Min v. Mitsui Bussan K.K.,23 the 1987 decision in which the Tokyo High Court rejected claims for damages in a case brought by a Malaysian businessman against Mitsui Bussan for breach of contract and violation of good faith in negotiating a joint venture.

The case is another vivid reminder that legal rules do matter. Indeed, it makes a point that is often overlooked or assumed away in discussions of why the Japanese resort to court less frequently than we do in the United States. Rarely are differences in the rules themselves noted. For example, Chapter 11, entitled "Dispute Resolution," provides an excellent description of the procedural aspects of litigation and arbitration in Japan, including the availability of "preliminary" injunctive relief, the importance of which is demonstrated in translated cases in other chapters. The chapter concludes with challenges to prevailing views that the Japanese judicial system fails because of aversion to litigation in general and the inability of judicial decisions to influence the outcome of settlements. The lack of a jury system in both civil and criminal cases, as well as the concern of Japan's career judges to ensure as much uniformity and certainty as possible, help to explain why the Japanese may be able to litigate less and still settle cases more frequently within the "shadow of the law," thus contributing to the efficiency of Japanese litigation as a means of enforcing legal rules. Missing here as elsewhere, however, are any references to the negligible amounts by U.S. standards that Japanese litigants can expect when they are successful in court or differences in judicial treatment of similar claims. We in America may sue more in part because we win a greater percentage of cases and are awarded larger monetary judgments.

In these respects, Law and Investment in Japan is itself a bold statement on the worth of lawyering in a world in which the nation-state seems to many to be overwhelmed by global economic forces. From contract formation to corporate forms, from controls over licensing agreements to regulation of capital markets, the legal rules of the nation-state remain the primary instrument for regulating trade and investment. Law and Investment in Japan reminds us that contracts and corporations are the creatures of national law and that economies prosper within

infrastructures sustained by law. It demonstrates the determinative role of national law and legal regimes.

American lawyers need to appreciate how legal rules are created, construed, and enforced beyond American shores. They need to know what the basic rules and standards are, or at least how to find them. Japan is a telling example. Its commercial importance and its influence as a model, especially in the emerging industrial states of the Asia Pacific region, are apparent. But Japan is not the only model. As Charles Stevens predicted a quarter-century ago, today’s lawyers confront daily similar problems on a global scale. They need to be exposed to more than a perspective overview of civil law systems. They require knowledge of the variety of legal rules and their operation in diverse legal systems, cultures, and traditions.

American lawyers have the capacity to contribute to transactions that profoundly influence the lives of us all through the innovation, development, and diffusion of new technologies and ultimately, the creation and equitable distribution of wealth on a global basis. There is more at stake, however. To equip lawyers to facilitate transactions related to trade and investment in Japan is also to equip them to solve problems related to human rights, environmental protections, and the full array of legal rules that are subject to national enforcement. It means educating future lawyers to function professionally and to assist in solving the myriad of problems in a world made so increasingly interdependent by these same forces of trade and technology. When it is emulated by those who teach European, Latin American, African, and South Asian law, then *Law and Investment in Japan* will have served this grander aim.