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YONSEI LAW JOURNAL

VOL. 3 NO. 2, NOVEMBER 2012

CONTENTS

ARTICLES

STUDENT PAPER

YONSEI LAW JOURNAL

VOL. 3 NO. 2, NOVEMBER 2012

ARTICLES

LEGAL ROUTES TO UNDUE INFLUENCE: VULNERABILITIES IN THE KOREAN NATIONAL HUMAN RIGHTS COMMISSION ACT

Douglas MacLean[*]

ABSTRACT

The National Human Rights Commission of Korea has operated in the midst of considerable political and governmental opposition since its creation. Heralded early on as the strongest national human rights institute in Asia, the government bureaucracy and conservative political forces have challenged the organization's operation from the very beginning. The inauguration of the Lee administration brought opposition forces into power, bringing drastic cuts and drawing both domestic and international criticism over alleged political interference with the organization's operation. Missing from the political accounts of the situation, however, is an examination of the structural vulnerabilities to government influence built into the very foundations of the Commission's legal regime. This article addresses that gap. Guided by the UN supported international criteria for assessing the independence and efficacy of national human rights institutions, this article analyzes both the structural and operational parameters of the Commission's enabling legislation. Particular vulnerabilities to government influence are identified and discussed, with recommendations for strengthening the Commission's legal independence provided.

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I. INTRODUCTION[1]

The National Human Rights Commission of Korea (NHRCK) has been cited as one of the strongest national human rights institutions in Asia.[2] Established through the support of domestic civil society groups[3] and an international push for national institutions to promote universal human rights in the 1990's,[4] the Commission quickly gained international praise for its independence.[5] However, the organization faces continued opposition from within the government, and domestic groups have long charged that government interference hobbles the agency. These complaints have grown stronger under the current Lee administration, and the agency has since faced domestic and international criticism for failing to follow through on its mandate.[6]

However, while threats to the agency's independence have been documented in English, almost no attention has been paid to the structural vulnerabilities to outside influence that are built into the agency's legal mandate. This article fills that gap by identifying structural and operational vulnerabilities to government influence that are built into the Commission's foundational legislation. Vulnerabilities identified include a lack of budgetary control, an appointment process dominated by the executive branch, and a lack of principles of interpretation to guide development of the Commission's legal mandate. Operationally, government agencies are able in many cases to decide when to respond to the Commission inquiries, creating a direct opening to influencing the agency's actions. At the same time, overly broad discretion in accepting or rejecting individual complaints of discrimination creates an indirect avenue for government influence.

In setting the stage for the legal analysis, part II examines the 10-year history of the Commission, discussing the impetus for the organization's creation, the political battle

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[1] My sincere thanks to Professor Kim Joongi of Yonsei University for his guidance on this topic and for his encouragement in publishing this article.

[2] Koo Jeong-Woo, *Origins of the National Human Rights Commission of Korea*, *in* SOUTH KOREAN SOCIAL MOVEMENTS 80, 80 (Shin Gi-Wook and Paul Chang eds., 2011). Note that this article follows the Korean language rule for Korean names, with family names first and personal names second.

[3] *Id.* at 83-85.

[4] *Id.* at 78.

[5] Louise Arbour, United Nations High Commissioner for Human Rights, Letter from High Commissioner for Human Rights to the Chairperson of the Transition Committee of the President of the Republic of Korea regarding the Independence of the National Human Rights Commission of Korea (Jan. 17, 2008), http://www.humanrights.asia/news/forwarded-news/AHRC-FST-006-2008.

[6] CHAU PAK-KWAN, HUMAN RIGHTS COMMISSIONS IN NORTHERN IRELAND, AUSTRALIA, SOUTH KOREA, AND INDIA 46 (2008).

surrounding its foundational legislation, and the criticisms that the government has faced over its interference with the agency. Turning to the legal analysis, part III explores how the Commission's statutory law influences its effective independence from the government. Provisions examined include both structural and operational features. The former include the agency's legal independence from the government, budgetary authority, Commissioner selection process and jurisdictional scope. Operational features examined cover the full range of advisory, investigatory and adjudicatory functions, with particular emphases on when the government must cooperate, and conversely, when the Commission must act. Throughout the analysis, practical vulnerabilities to government influence will be discussed, with particular attention paid to the government's control over the structural aspects of the organization, as well as on the potential for indirect influence through the NHRCK's broad discretionary powers in defining and carrying out its mandate. Finally, recommendations for addressing these legal vulnerabilities will be provided.

By unpacking and carefully analyzing the NHRCK's fundamental legal machinery, this article seeks to provide an important introduction to the Commission's structural vulnerabilities to influence, and to provide recommendations for addressing these shortcomings. This analysis will be useful to practitioners and activists intent on strengthening the organization, while also serving as a launching point for research into the Commission's current implementation of its legal mandate. It is the author's hope that this analysis also serves as a template for examining other national human rights institutions as well.

In order to put the legal analysis in perspective, we begin with a brief examination of the NHRCK's history to date.

II. THE PUSH FOR A NATIONAL HUMAN RIGHTS COMMISSION IN KOREA

Encouraged by Korea's then-growing connection to the international human rights movement, domestic civil society groups began advocating for the establishment of a national human rights commission in the early 1990's.[7] With former human rights activist Kim Dae Jung's successful presidential run in 1997, the Commission's creation began in earnest.[8] However, government bureaucrats opposed to such an agency fought to subvert the NHRCK's

[7] Koo, *supra* note 2, at 83-85.
[8] President Kim made a campaign pledge to create such an institution. Koo, *supra* note 2, at 78.

independence by attempting to place the Commission under the Ministry of Justice.[9] Civil society eventually won out by pressuring elected officials to reject such proposals, thus securing the agency's formal independence from the rest of the government.[10]

Still, the Commission's foundational legislation remained highly controversial, passing by only four votes in a legislative body of 270 members.[11] Conservatives from both the opposition Grand National Party and within Kim's own party opposed the legislation, presaging the ongoing conflict over the organization's activities.[12] During negotiations, various ministries sought to cabin off parts of their own operations from the Commission's jurisdiction. When that failed, they later sought to water down an implementing decree in order to limit the Commission's authority.[13] However, civil society criticism of bureaucratic opposition provided pushback against such attempts, setting the stage for continued domestic conflict over the agency and underscoring the challenges the Commission would face in engaging uncooperative government actors.[14]

Ultimately, the organization launched in 2001 with a level of independence surpassing those of similar entities in other Asian countries.[15] Positive assessments of its early years describe it as rapidly gaining the public's trust, as well as enjoying a level of influence with the National Assembly.[16] More critical observers charged that the NHRCK suffered from a high degree of political interference, a lack of financial independence and autonomy in personnel matters, and insufficient investigation powers that were coupled with overly broad discretion to reject complaints filed by individuals alleging human rights violations.[17] Regardless, the Kim and succeeding Roh administrations continued to support the Commission, with the latter amending the National Human Rights Commission Act

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[9] *Id.* at 79.
[10] *Id.* at 79.
[11] *Id.* at 79.
[12] *Id.* at 79.
[13] *Id.* at 79-80.
[14] *Id.* at 80.
[15] Including Indonesia, Malaysia, the Philippines and Thailand. *Id.* at 80. For a brief overview of these countries' human rights institutions, *see* HSIEN-LI TAN, THE ASEAN INTERGOVERNMENTAL COMMISSION ON HUMAN RIGHTS: INSTITUTIONALISING HUMAN RIGHTS IN SOUTHEAST ASIA 72-136 (2011).
[16] Researchers observed that the Commission's recommendations for new legislation were reportedly highly regarded, even if not always followed. For example, recommendations on conscientious objectors to military service spurred the government to draft alternate legislation, while those to abolish capital punishment were not followed. *See id.* at 80. *See also* Bae Sangmin, *South Korea's De Facto Abolition of the Death Penalty*, 82 PACIFIC AFFAIRS 407, 420 (2009) (NHRCK recommendation for abolition of death penalty fails due to conservative opposition in National Assembly).
[17] CHAU, *supra* note 6, at 45.

(NHRCA)[18] in an effort to further strengthen the independence and functions of the NHRCK.[19] Despite continued criticisms from some Korean NGOs that the NHRCK had accomplished relatively little throughout the decade,[20] the organization's track record of independence was internationally recognized. The UN High Commissioner for Human Rights in 2008, for example, described the body as having an "excellent reputation in the international human rights system."[21]

However, the inauguration of the conservative Lee Myung-bak administration in the same year ushered in a government hostile to the NHRCK. In an apparent effort to severely constrain the organization's independence, the Lee administration attempted to move the Commission into the President's Office.[22] However, strong opposition from civil society,[23] the UN High Commissioner for Human Rights,[24] and NHRCK Commissioners led the administration to scrap the plan.[25] Instead, the government drastically cut the Commission's budget, downsizing it by 21% in 2009.[26] Furthermore, a 2009 UN review of Korea's implementation of the International Convention on Economic, Social and Cultural Rights charged that the Lee government's continued pressure on the Commission threatened its independence, to the point that it jeopardized the organization's accreditation with the International Coordination Committee of National Institutions (ICC).[27] By raising the issue of

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[18] This is the main law that defines the scope and power of the NHRCK. Presidential decrees available in English do not address the issues discussed in this article.

[19] Chau, *supra* note 6, at 35.

[20] *Cf.* Joint Korean NGOs, NGOs' ALTERNATIVE REPORT TO THE UN COMMITTEE ON ECONOMIC, SOCIAL AND CULTURAL RIGHTS ON THE THIRD PERIODIC REPORT SUBMITTED BY THE REPUBLIC OF KOREA (Sept. 2009) (Complaints alleging actions of the Lee government in 2008-09 "have quickly counteracted what little was accomplished by the NHRCK before."), *available at* http://www2.ohchr.org/english/bodies/cescr/docs/info-ngos/JointKoreanNGOs_KOR43.doc.

[21] Arbour, *supra* note 5.

[22] CHAU, *supra* note 6, at 46. The rationale given for this attempted move was that the NHRCK's independence violated the principle of separation of powers. *Id.*

[23] Joint Korean NGOs, *supra* note 20, at 13.

[24] Arbour, *supra* note 5.

[25] CHAU, *supra* note 6, at 46.

[26] U.N. Economic and Social Council, Comm. on Economic, Social and Cultural Rights, 43d Sess., Nov. 2, 2009 - Nov. 20, 2009, *Consideration of reports submitted by States parties under articles 16 and 17 of the Covenant: Concluding observations of the Committee on Economic, Social and Cultural Rights*, ¶ 8, U.N. Doc E/C.12/KOR/CO/3 (Dec. 17, 2009).

[27] U.N. Economic and Social Council, *Id.* at ¶8, Accreditation is based on the Paris Principles, which will be discussed further on. *See* Paris Principles, *infra* note 33. The Principles require National Human Rights Institutions to protect and promote human rights, and that they meet six main criteria, discussed below. *See ICC Sub-Committee on Accreditation*, http://nhri.ohchr.org/EN/AboutUs/ICCAccreditation/Pages/default.aspx (last visited Oct. 5, 2012). Note that failure to meet ICC standards can result in a downgrade in an organization's membership status with the ICC, and a subsequent loss in voting rights with the international body. *Id.* While this would have little effect on the NHRCK's internal functioning, it would at the very least have diplomatic consequences that the

its accreditation, the review essentially accused the NHRCK of moving away from the principles the international community had set to guide the functioning of national human rights institutions. In 2010, NGOs further accused the government of interfering with the organization, charging that the current Commission President (CP), appointed by Lee, had no expertise in human rights, and by implication was merely a puppet of Lee.[28] International human rights observers also criticized the new CP's failure to speak out or to act on a range of significant human rights issues, while several Commissioners resigned in protest over the new CP's actions, only to be replaced by individuals who observers charged were politically motivated appointments.[29]

On the whole, political opposition to the organization has had a degree of success in compromising the Commission's independence and thus its ability to carry out its mission. Why the opposition has been able to do so, however, requires an understanding of how the organization's fundamental statutory structure leaves the Commission vulnerable to attacks by hostile government and political forces. In part III, we will explore both the structural features and operational powers set out in the Commission's foundational legislation, with an eye towards assessing the agency's legal protections from and vulnerabilities to government influence.

III. STATUTORY STRUCTURE: EXPLORING THE COMMISSION'S INHERENT VULNERABILITIES TO INFLUENCE

Criticisms against the NHRCK focus on an alleged lack of independence from the government,[30] and its resulting ineffectiveness in carrying out its mandate.[31] Unfortunately, English sources have not addressed a fundamental legal question, namely the extent to which the NHRCK's legal structure exposes it to governmental influence, thereby undermining its independence.[32] Although a complete examination of all relevant legislation is necessary for a

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Korean government would have to consider. For a general treatment of the ICC, the Paris Principles, and how national human rights institutions are connected on the international level, *see* KJÆRUM MORTEN, NATIONAL HUMAN RIGHTS INSTITUTIONS IMPLEMENTING HUMAN RIGHTS 16-19 (2003).

[28] Joint Korean NGOs, *supra* note 20, at 14.

[29] *See Leadership Row Shakes Human Rights Watchdog*, KOREA HERALD, Nov. 02, 2010; *see also Amnesty International, Annual Report 2011: South Korea*, AMNESTY INTERNATIONAL (2011), *available at* http://www.amnesty.org/en/region/south-korea/report-2011.

[30] CHAU, *supra* note 6, at 45.

[31] Joint Korean NGOs, *supra* note 20.

[32] I use the term independence to mean freedom from governmental influence, and the ability to take

full accounting of such structural vulnerabilities, an analysis of the NHRCA provides an important first step in assessing vulnerabilities to influence at the foundational level.

This part will be divided into three sections. Section A introduces the methodology used in analyzing the NHRCA. Section B examines vulnerabilities in the Commission's organizational structure. Finally, Section C analyzes the operational provisions elaborated in the NHRCA.

A. METHODOLOGY

This article relies upon the UN promulgated Paris Principles to identify key areas of potential vulnerability to government influence.[33] For each area identified, relevant NHRCA provisions are analyzed to assess the degree to which government actors may directly or indirectly influence the Commission. In laying out this approach, this section begins with an explanation of this article's singular focus on the NHRCK rather than on a comparative analysis. It then discusses the Paris Principles and their use as broad guidelines rather than as concrete criteria. Specific considerations of potential influence that informed the analyses and recommendations made in the following sections are then discussed. This section concludes with an examination of the limitations inherent in the approach taken.

1. THE COMPARATIVE VERSUS ORGANIZATION-SPECIFIC APPROACH

As should already be clear, this article focuses solely on the NHRCK and its relevant legislation. While a comparative analysis is useful for identifying the *relative* strengths and weaknesses of the NHRCA, it sacrifices a deeper focus on a single entity for a broader perspective. As useful as comparative approaches are in this field, my goal instead was to analyze how *this* particular institution's fundamental legislation shields or exposes it to undue influence from its own government.[34]

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action or to compel other entities to act in order to carry out the NHRCK's mandate.

[33] U.N. General Assembly [UNGA], National Institutions for the Promotion and Protection of Human Rights, U.N. Doc. A/RES/48/134 Annex (Dec. 20, 1993) [hereinafter Paris Principles].

[34] It should also be noted that different countries can employ very different styles of human rights institutions, which can further complicate a comparative legal analysis approach. *See* OFFICE OF THE HIGH COMMISSIONER FOR HUMAN RIGHTS, NATIONAL HUMAN RIGHTS INSTITUTIONS: HISTORY, PRINCIPLES, ROLES AND RESPONSIBILITIES, at 31, U.N. Doc. HR/P/PT/4/Rev.1, U.N. Sales No. E.09.XIV.4 (2010) [hereinafter Guidelines for the Paris Principles]. Indeed, a country may have multiple independent agencies that together carry out the functions of an NHRI. While this does not rule out a comparative approach, it does highlight the importance of also examining each institution

Additionally, comparisons with international frameworks suffer from a lack of detailed standards to measure the health of such institutions. The international community to date has only agreed upon baseline standards of institutional quality. These standards are the Paris Principles,[35] which are employed by the ICC to evaluate the effectiveness and overall health of national human rights institutions (NHRI).[36] They provide minimum standards that NHRI's should follow in attaining and maintaining accreditation with the ICC. The ICC's examination process has underscored the role of the Principles as a baseline by awarding the top accreditation status to 69 countries that range from poor countries like Afghanistan to wealthier ones like Denmark and South Korea.[37] The Paris Principles are thus not on their own effective as a tool in examining the particular vulnerabilities to influence that a fully accredited NHRI faces.

2. THE PARIS PRINCIPLES

Despite the limitations described above, the Paris Principles do provide useful guidance by elaborating the specific features necessary for a healthy and effective NHRI. These criteria include: 1) independence guaranteed by legislation or the Constitution of the Republic of Korea, 2) a broad mandate and competence based on universal human rights norms and standards, 3) autonomy from the government, 4) adequate resources, 5) adequate powers of investigation, and 6) adequate pluralism of Commissioners.[38]

It is clear from these criteria that independence, mandate, and resources form the bulk of the assessment. Furthermore, these criteria overlap in places; autonomy from the government is particularly broad and would include both an organization's funding, structure and the extent to which it must rely on government cooperation in carrying out its functions.

As mentioned previously, given Korea's full accreditation with the ICC, a simple analysis of the NHRCA's provisions in light of the Paris Principles is a poor tool for

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within its own national context in order to understand what makes a particular NHRI vulnerable to influence.

[35] Paris Principles, *supra* note 33.

[36] *See ICC Sub-Committee on Accreditation, supra* note 27.

[37] *See* ICC, CHART OF THE STATUS OF NATIONAL INSTITUTIONS (May 2012), *available at* http://nhri.ohchr.org/EN/Documents/Forms/AllItems.aspx.

[38] Paris Principles, *supra* note 33. Adequate pluralism is discussed at length in Kjærum, *supra* note 26, at 8. An examination of the pluralism of the NHRCK's board of Commissioners throughout its existence and the impact this has had upon its independence is beyond the scope of this article. Suffice it to say that, beyond the mandatory minimum 50% female representation on the Commission, the NHRCA makes no provisions guaranteeing other forms of pluralism among Commissioners; *see* NHRCA, *infra* note 44, art. 5(5).

uncovering the potential vulnerabilities to influence.[39] In the absence of an appropriate framework, this article employs the broad criteria established in the Paris Principles, combined with a more general set of tools, to assess the Commission's vulnerabilities to government influence.[40]

3. SCOPE AND FOCUS OF ANALYSIS

With the above considerations in mind, two key areas of the NHRCA merit close attention. The first is the institutional structure of the organization, which includes its 1) official legal independence, 2) the scope of the organization's mandate, 3) the composition and selection process of its members, and 4) its independent budgetary authority. Second are its formal powers in carrying out its mandate, including its 1) research and advisory powers and 2) its investigative and adjudicatory powers that it exercises in response to individual complaints.

For each of these areas, the analysis focuses on how the NHRCA's relevant provisions may expose the Commission to outside influence. The greater the exposure, the more likely the Commission's independence is threatened in that area. In analyzing the NHRCA's provisions, the following forms of potential influence are considered:

1. The extent to which the government can directly influence the NHRCK.
2. The potential for indirect government influence exists.
3. The NHRCK's discretionary power and the situations in which it is compelled to take action.

The first item includes such perennial issues as funding and selection of Commissioners. Indirect influence focuses mostly on areas where the Commission lacks the power to independently compel action, i.e. those that make the agency dependent upon the government's cooperation. Similarly, the breadth of the NHRCK's discretionary power can provide an opportunity for the government to influence the agency. Commissioners friendly to the government can refuse to take action, or the Commission can decide not to exercise a

[39] Despite concerns from the U.N. High Commissioner for Human Rights, to date the ICC has not downgraded the NHRCK, although it is not clear whether the ICC could do so prior to the next review of a country. *See* ICC, CHART OF THE STATUS OF NATIONAL INSTITUTIONS: ACCREDITATION STATUS AS OF MAY 2012, at 3 (2012). South Korea's next review is in 2013. *See ICC Sub-Committee on Accreditation, supra* note 27 (member states undergo accreditation review every five years). Additionally, it is unclear how the ICC uses these criteria to set an organization's ranking.

[40] In addition, the Office of the High Commissioner for Human Rights has published guidance for practitioners explaining each of these criteria, and I will refer to these as appropriate. *See* Guidelines for the Paris Principles, *supra* note 34.

discretionary power in order to secure government cooperation in other activities. While mandating that the agency research all human rights issues and investigate all claims regardless of their merits is fiscally and logistically impossible, overly broad powers of discretion run the risk of enabling and even concealing government influence. This third point is particularly relevant, given the various criticisms over the NHRCK's decisions not to take action.[41]

4. LIMITATIONS

The author's reliance upon English language sources naturally limits the range of available primary source documents. The analysis is thus focused squarely on the NHRCA as rendered in English and the implications it holds for government influence over the Commission.[42] While research was conducted in consultation with a Korean legal scholar,[43] the author is not privy to the daily practices of the Commission. Readers more knowledgeable about the actions of the NHRCK will therefore have a better understanding of the extent to which the NHRCA's provisions are implemented, and the depth to which the vulnerabilities identified in this article are exploited. Ultimately, the goal of this analysis is to uncover the structural vulnerabilities built into the NHRCK's legal mandate, offer solutions for addressing them through legal revision, and to provide a foundation for additional legal research.

Finally, legal revision on its own is not a panacea for addressing challenges to the NHRCK. Political will and civil society efforts to build a culture of respect for the institution and its independence will be necessary to secure an effective organization more resistant to government influence.

We now turn to the analysis, beginning with an examination of the Commission's institutional structure as set forth in the NHRCA.

B. INSTITUTIONAL STRUCTURE

Despite fairly clear language mandating its independence, the NHRCK is still a government body, with Commissioners chosen and operational funds granted by the

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[41] *See* Joint Korean NGOs, *supra* note 20.

[42] Potential discrepancies between the English and Korean versions, particularly in how particular terms are interpreted must also be kept in mind. Implementing the recommendations outlined in this article will require confirming the interpretation of existing provisions and ensuring that proposed language in Korean accomplishes the goals that these recommendations seek to achieve.

[43] Dr. Kim Joongi, Professor, Yonsei Law School, Seoul, Republic of Korea.

government. The following subsections thus examine the provisions in the NHRCA to make the office officially independent, provide a sufficiently broad mandate, secure financial resources, and assign responsibility for selection of top level staff. Each of these areas will be introduced with a description of the law, followed by an analysis of how relevant provisions contribute to or threaten the body's independence, and concluded with recommendations for addressing the problems identified.

1. OFFICIAL LEGAL INDEPENDENCE

The NHRCA makes clear that the Commission is to be set apart from the rest of the government, beginning with a provision entitled the "Establishment and Independence of the National Human Rights Commission."[44] In addition to declaring the creation and establishing the mission of the organization, the provision dictates that the Commission must "independently deal with the matters which fall under its jurisdiction."[45]

Analysis

On the one hand, this language clearly satisfies the basic requirement under the Paris Principles that a human rights commission be empowered to act independently.[46] On the other hand, it fails to explicitly state that the organization is situated independently of the rest of the government. While the language above implies that placing the agency anywhere within an existing government hierarchy would necessarily compromise its independence,[47] this did not stop the Lee administration from attempting to "clarify" the agency's position by relocating it to the President's Office.[48]

Recommendations

Amending the NHRCA to explicitly position the Commission apart and independent

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[44] National Human Rights Commission Act, Act No. 6481, May 24, 2001, art. 3 (S. Kor) translated in Statutes of the Republic of Korea (Korea Legislation Res. Inst.) [hereinafter NHRCA].
[45] *Id.* art. 3(2).
[46] *See* Paris Principles, *supra* note 33. ("Composition and guarantees of independence and pluralism," art. 2). *See also* Guidelines for the Paris Principles, *supra* note 34, at 37-39.
[47] Indeed, guidelines for implementing the Paris Principles state that placing an NHRI within a governmental ministry would void its independence. *Id.* at 40.
[48] *See* CHAU, *supra* note 6, at 46.

from the rest of the government would render such attempts legally more difficult.

2. SCOPE OF THE NHRCK'S MANDATE

The Commission enjoys a broad mandate to "ensure that inviolable fundamental human rights of all individuals are protected and the standards of human rights are improved."[49] Human rights itself broadly includes "any of [sic] human dignity, worth, liberty and rights which are guaranteed by the Constitution and Acts of the Republic of Korea," international treaties of which Korea is a party, and customary international law.[50] The rights of both Korean nationals and foreigners "residing" within Korea fall within the Commission's purview.[51] Within this widely drawn jurisdiction, the Commission is required to act independently on all relevant matters.[52]

The Commission's mandate could hardly be broader and is thus in line with the Paris Principles on this point.[53] It is expansive enough to cover both the current scope of human rights as well as new issues that develop in the future.

Analysis

The NHRCA however fails to provide any direction on how the Commission should interpret its mandate on issues of first impression. Essentially free to shape its own jurisdiction, an aggressive body of Commissioners could drive the development of human rights in Korea, declaring a particular issue apropos through an interpretation of the Constitution or relevant international legal instrument. Equally possible, however, are interpretations that narrow its jurisdiction and thus limit the Commission's ability to act in certain areas. In fact, the current Commission President has been accused of doing just this by ruling that certain issues are outside the bounds of "human rights."[54]

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[49] NHRCA, *supra* note 44, art. 1.

[50] NHRCA, *supra* note 44, art. 2(1). A discussion of the extensive human rights protections guaranteed under the Constitution is unfortunately beyond the scope of this article. *See generally* DAEHANMINKUK HUNBEOB [HUNBEOB] [CONSTITUTION] arts. 10 - 37 (S. Kor.).

[51] NHRCA, *supra* note 44, art. 4. It is not clear whether the term "reside" includes those present without legal residence.

[52] NHRCA, *supra* note 44, art. 3(2).

[53] *See ICC Sub-Committee on Accreditation, supra* note 27.

[54] Two such rulings include holding that prosecutors' investigation methods, as well as a government-imposed ban on nighttime rallies, are outside the scope of "human rights," and thus outside the Commission's jurisdiction. *See* Bae Ji-sook, *Revolt Persists at Human Rights Agency,* THE KOREA

With no clear guidance on approaching new issues, the NHRCK has seemingly broad power to elaborate the scope of existing human rights protections, enabling it to legally address or ignore certain cases as it chooses.[55] Ultimately, while a broad mandate is important to ensure that the organization can accommodate, incorporate and even help advance evolving human rights norms, the discretion Commissioners enjoy in interpreting the NHRCK's purview creates an opportunity for outside influence.

Recommendations

Governmental pressure can influence the Commission to employ its discretion in a negative way, defining certain sensitive issues out of the scope of its jurisdiction. Limiting that discretion will be important to limiting the impact of outside influence. Two recommendations in this area are in order:

1. Establish canons of interpretation that favor broad interpretations of the Commission's mandate.
2. Require the Commission to establish a clear and transparent process for determining the scope of its mandate and that it publishes its reasons for its decisions.

Balancing interpretive freedom against the potential for self-censorship is a difficult one. However, the NHRCA would benefit from the inclusion of general principles of interpretation that are in keeping with the Commission's envisioned broad jurisdiction and duty to act.[56] In theory, the NHRCK's mandate requires interpretation in cases of first impression. Where the cases are not frivolous, these will likely be controversial issues where international and domestic human rights laws are unclear or unsettled. In keeping with the Paris Principles that require NHRIs to have as broad a mandate as possible,[57] and indeed to further advance human rights generally, the NHRCA should include language that preferences broad

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TIMES, Nov. 10, 2010.

[55] Note that this power likely extends in practice only to those areas that have not been widely recognized as human rights. Rights already clearly elaborated in the Constitution, in international instruments, and in court decisions are likely to be off-limits to reinterpretation. Issues at the margins are where this power will be most relevant. Such areas, however, are often the most critical ones, as they are where the normative structure of human rights continues to develop and advance. While beyond the scope of this article, it would also be worth studying what effects the NHRCK's declarations have had on promoting or impeding the recognition of a particular issue as falling within the scope of existing human rights in Korea.

[56] NHRCA, *supra* note 44, arts. 1, 2(1), 3(2).

[57] Guidelines for the Paris Principles, *supra* note 34, at 31-32.

interpretations of the mandate over narrow ones. In short, a relatively high bar to ruling an issue currently not settled in law as pertaining to human rights and thus to the NHRCK's mandate will be necessary.

Provisions that 1) clearly states that the NHRCK's mandate shall be interpreted in a way that ensures as broad and inclusive reading of relevant domestic international law as possible and that 2) to the greatest possible extent, avoids interpretations that narrow its mandate, should therefore be pursued. At the end of the day, no airtight definition will be possible, and indeed extensive negotiation over the most appropriate phrasing in Korean will be necessary. However, compared to the complete lack of guidance in the NHRCA on this point, canons of interpretations that favor expansive readings of the mandate will help guard against overly restrictive interpretations, while also holding the Commission accountable to the goal of having as broad a mandate as possible.

Secondly, sun shining the NHRCK's decision-making process in this area will be a key to ensuring that guiding language on interpreting its mandate is in fact being followed. As controversial issues can have political implications that expose Commissioners to governmental pressure, an imperative to publish the reasons for rejecting an issue as outside the scope of domestic and international human rights laws would provide a legal counterbalance against restrictive interpretations. It would also set the tone for how Commissioners, regardless of political loyalties, delineate the body's mandate going forward.[58]

Overall, the institutional structure that the NHRCA establishes provides an incredibly broad mandate, along with a measure of independence for Commissioners to carry it out. However, a lack of budgetary authority threatens the agency's independence, while the Commissioner selection process, particularly for the CP, is highly susceptible to government influence. Finally, overly broad discretion in defining its mandate enables the government to apply pressure, either directly or indirectly, to push the Commission to declare certain issues outside of its jurisdiction.[59]

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[58] Not inconsequentially, it would also provide a valuable record for how the Commission advances the field of human rights in South Korea, and could also prove useful as a comparative tool when examining other NHRI's.

[59] As will be seen in the next section, broad discretion in the organization's operational powers create similar vulnerabilities to governmental influence.

3. BUDGET

In contrast to official independence outlined earlier, the NHRCA's budgetary provisions place the purse strings under the control of the Ministry of Justice.[60] In fact, despite the CP's position as the controlling officer of the Commission, he or she has no power over compiling the budget.[61]

Analysis

Although the Ministry was not successful in placing the Commission directly under its purview during its formation,[62] budgetary control enables the Ministry to exercise a great deal of practical influence over the organization. Any potential investigations into the Ministry will necessarily be hampered by the potential threat of budget cuts in retaliation. While specifics on governmental funding mechanisms are beyond the scope of this article, the Ministry, and by extension the President's office, have significant leeway in requesting and approving budgetary allocations for the NHRCK. Additionally, including the NHRCK's budget within that of the Ministry weakens direct legislative oversight of the Commission's budget. Worse yet, the Ministry is responsible for defending the funding of an institution charged with investigating the same ministry, creating a conflict of interest and an avenue for both direct and indirect influence. Whether cuts to the NHRCK in 2009 mentioned in part II were due to the Lee administration itself requesting a lower funding level or instead were the result of ministerial cuts to the Commission within an already approved budget framework, budgetary authority resting with a government Ministry is a serious breach of the Commission's independence.[63]

Recommendations

Budgetary autonomy is key to the Commission's overall independence, and guidance on

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[60] CHAU, *supra* note 6, at 40.

[61] *See* CHAU, *supra* note 6, at 40. In fact, the word "budget" is mentioned only once in the Act, in reference to a technical change to the CP's legal position when performing duties related to the Commission's budget. NHRCA, *supra* note 44, art. 6(5).

[62] Koo, *supra* note 2, at 79.

[63] Despite complaints about the current CP's loyalty to the Lee administration, the NHRCK annual report in 2010 repeatedly lamented the challenges it faced to its mandate due to drastic funding cuts the year before. National Human Rights Commission of Korea, *Annual Report 2010,* at 15 (Jun. 2011) [hereinafter NHRCK Annual Report].

the Paris Principles published by the Office of the UN High Commissioner for Human Rights emphasizes this point.[64] While the guidance unfortunately labels ministerial authority over an NHRI's budget as merely "less advisable," its suggestion that NHRI's should have an independent budget line over which it has absolute management and control, and which it can directly advocate to the legislature, is sound.[65] Amendments to the NHRCA should therefore make the following changes:

1. Clarify that the Commission has the power to compile its own budget as a line item independent from all other government agencies.
2. Make the NHRCK responsible for submitting and defending its budget to the National Assembly during the regular budgetary process.[66]
3. Add clear language that commits funding sufficient for the Commission to carry out its functions.

These amendments would eliminate the Ministry of Justice's financial power over the Commission, and would set a stronger commitment to funding the NHRCK, weakening the potential for retaliation by a hostile legislature or President. While the political considerations inherent in government budgeting make complete budgetary security impossible,[67] strengthening budgetary autonomy would remove a critical vulnerability to influence, while a clearer budgetary commitment would ensure greater stability and thus autonomy for the Commission.

4. SELECTION AND RETENTION OF COMMISSIONERS

The Commission is composed of eleven members, including one president and three full-time Commissioners.[68] Appointments are split 4-4-3 between the Korean President's office, the National Assembly and the Chief Justice of the Supreme Court, respectively.[69] Two of the three full-time members are appointed by the National Assembly.[70] Who selects the third member is not specified in the English version of the Act.[71] Nominees must have

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[64] Guidelines for the Paris Principles, *supra* note 34, at 40-41.
[65] *Id.*
[66] Ideally, the NHRCK's budget should be approved on an agency level rather than on an item-by-item basis to ensure the Commission's autonomy in allocating its resources.
[67] *See also* Guidelines for the Paris Principles, *supra* note 34, at 39 ("The very fact that an NHRI is a State body funded by the State raises difficulties").
[68] NHRCA, *supra* note 44, art. 5(1).
[69] NHRCA, *supra* note 44, art. 5(2).
[70] NHRCA, *supra* note 44, art. 5(2).
[71] This Commissioner could thus come from either the President's or the Supreme Court's nominees.

"professional knowledge and experience on the matters of human rights," and be able to carry out their duties of protecting and improving human rights in a fair and independent manner.[72]

Once the nomination roster has been set, the Korean President selects the Commission President from the list of nominees.[73] The CP and full-time Commissioners are explicitly designated political appointees under the law,[74] although somewhat paradoxically, members of political parties and candidates for political office are disqualified from serving as Commissioners.[75] All Commissioners serve for three years and may be reappointed for an additional term.[76] Commissioners cannot be removed unless they are convicted of a serious crime.[77]

Analysis

On the whole, the selection and retention process protects Commissioner independence to some extent. The strongest provision by far is the extremely high bar the government faces in removing members. Furthermore, dividing appointment powers among different governmental bodies disperses selection authority, making it difficult for the governing party to pack the Commission with its supporters. However, the process ultimately tilts toward the President's Office and its selection of the CP, and it is here where the government can particularly influence the Commission. The CP is no mere figurehead; he or she is not only the face of the Commission, but also has broad power to direct the body's affairs.[78] The CP can thus greatly influence how much, or how little, the NHRCK accomplishes. An administration hostile to the NHRCK could simply nominate a loyalist who would be less likely to investigate issues that could harm or embarrass the administration.[79] Note also that the criteria for serving as a Commissioner is fairly broad, and if the criticisms about the current CP are to be believed, do not effectively deter the President from picking someone

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[72] NHRCA, *supra* note 44, art. 5(2).
[73] NHRCA, *supra* note 44, art. 5(3).
[74] NHRCA, *supra* note 44, art. 5(4).
[75] NHRCA, *supra* note 44, art. 9(1), (2). During their term, Commissioners are also prohibited from joining political parties, attaining elected office, or serving as a public official of any state or local government, except for education officials, who are allowed to serve concurrently as Commissioners. NHRCA, *supra* note 44, art. 10.
[76] NHRCA, *supra* note 44, art. 7(1).
[77] NHRCA, *supra* note 44, art. 8. Removal is also possible due to physical or mental health reasons, but requires assent by 2/3rds of all Commissioners. *Id.*
[78] NHRCA, *supra* note 44, art. 6(1) ("The president of the Commission shall represent the Commission and exercise the overall control of the affairs thereof").
[79] As the Lee government has been accused of doing. *See* Joint Korean NGOs, *supra* note 20, at 14.

without human rights experience.

Political opposition aside, even Presidents friendly to the Commission could be tempted to select a CP who is less likely to thoroughly investigate potentially embarrassing or politically damaging issues. The possibility of reappointment also means any CP interested in seeking a second term could face pressure to constrain their activities in order to obtain reappointment to the Commission. As reappointment is possible for all Commissioners, those appointed by the National Assembly are also open to similar pressure.[80] With eight of the eleven members selected by the political branches, and the CP selected by the President, appointment and reappointment are thus avenues to political influence that can threaten the Commission's independence.

Recommendations

Decreasing the level of government influence inherent in the nomination process will require several structural changes:

1. Move the nomination of the CP from the President to the Commissioners.
2. Lengthen the terms of service so that politically appointed Commissioners outlast the President or the legislature that installed them.
3. Investigate the balance of power between the CP and the rest of the Commission.

Starting with the CP, moving the nominating and reappointment powers from the President to the Commission itself would go a long way to alleviating Presidential influence. A majority vote of Commissioners at the very least should be required to select or reappoint the CP, and given that 8 out of 11 members are selected by the political branches, requiring the majority vote to include at least one if not two votes by the Supreme Court nominated Commissioners would further insulate the process from political influence.[81]

Secondly, concerns about influence over the reappointment process could be addressed

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[80] Note that this particular concern implies that Commissioners seek to be reappointed. Resignations in protest over the Lee government, and even the early resignation by then CP Ahn Kyong-Whan, show that at least some recent Commissioners have put principle over reappointment. *See* Park Si-Soo, *Korea on Verge of Becoming Shameful Nation*, THE KOREA TIMES, Jul. 08, 2009. Still, this structural weakness remains, and Commissioners appointed by the political branches who wish to serve a full six years will certainly feel pressure to conform their actions to ensure reappointment.

[81] In a system where the President's office and the National Assembly are controlled by separate parties, the current selection process would represent a balance of opposing powers. As of October 2012, President Lee's Saenuri Party controls the National Assembly, amplifying his party's voice in the selection process. *See Members by Negotiating Group*, NATIONAL ASSEMBLY OF THE REPUBLIC OF KOREA, http://korea.na.go.kr/mem/mem_04.jsp (last visited Oct 12, 2012).

by lengthening terms of service such that either the President or the legislature will have changed by the time their term is completed. This will make the CP in particular less beholden to the President who nominated him or her, and would help alleviate potential influence over other Commissioners as well.

Finally, it may also be the case that the CP wields too much power. If so, the President's appointment power gives him or her potentially outsized influence over the Commission. Research into the Commission's now decade of operation should provide sufficient information on whether this is so. Given NGO complaints about the current CP's loyalty to the President and his overall ineffectiveness,[82] revisiting the distribution of power between the CP and the Commissioners as a whole may be in order. In addition to moving election of the CP away from the President's office, weighing the advantages and drawbacks between a strong CP and a dispersed leadership structure[83] will require assessing the NHRCK's track record to date, as well as the experience of similar bodies in other countries.

C. OPERATIONAL POWERS

The NHRCK's mission includes research and advisory functions, as well as powers to investigate and adjudicate individual complaints of human rights violations. The ability to carry out these functions without having to depend on government cooperation, the power to compel action when necessary, and the imperative for the Commission to take action determine how well the organization can remain independent from and thus resist undue government influence. As we will see, the NHRCK's powers range from hortatory recommendations to binding decisions, with fines and other criminal penalties available to reinforce some of its investigatory powers. Ultimately deciding when to engage these powers is largely left to the discretion of the Commission, providing an opening for outside actors to pressure the organization against taking action. This section will first examine the Commission's largely non-binding research and advisory powers and then turn to its more coercive investigatory functions. As before, each of these areas will be introduced with a description of the law, followed by an analysis of how relevant provisions contribute to or threaten the body's independence, and conclude with recommendations for addressing the problems identified.

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[82] *See e.g.* Bae Ji-sook, *Revolt Persists at Human Rights Agency*, THE KOREA TIMES, Nov. 10, 2010.

[83] One consideration, for example, is the greater susceptibility of a single individual to outside influence versus the potential for less focused leadership and direction inherent in a committee-run structure.

1. RESEARCH AND ADVISORY POWERS

The Commission is empowered to research and comment on a wide range of government activities, from legislative acts and subordinate statutes to "institutions, policies and practices related to" human rights. Although merely advisory, it may offer its input as necessary,[84] and may also submit opinions to any court on pending cases that implicate human rights.[85] Additionally government agencies intending to establish acts or regulations "likely to affect the protection and improvement of human rights" must notify the Commission in advance of promulgation.[86] Together, these provisions enable the Commission to proactively investigate relevant issues while also ensuring (at least on paper) that government organs bring relevant matters to its attention.

In carrying out its mandate, the Commission may engage both government and private organs through methods that have different levels of binding force. At the least coercive level is the broad power to request consultations with any governmental entity at any time the Commission deems necessary to carry out its duties.[87] Governmental agencies may refuse such requests, provided there exists "any justifiable reason."[88] The Act however does not require this reason to be communicated to the Commission.[89] Written justification *is* mandatory when an agency refuses to follow a Commission recommendation that suggests changes to policies or practices in order to protect or improve human rights.[90] The Commission can in turn publish both its recommendation and the agency's response if it so desires.[91] Finally, in the performance of any of its duties, the Commission may compel submission of "relevant materials" from government agencies, who must comply "without delay."[92] It can also order representatives of relevant entities, whether governmental or private, to appear at hearings and give testimony.[93]

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[84] NHRCA, *supra* note 44, art. 19(1).
[85] NHRCA, *supra* note 44, art. 28.
[86] NHRCA, *supra* note 44, art. 20(1).
[87] NHRCA, *supra* note 44, art. 20(2).
[88] NHRCA, *supra* note 44, art. 20(3).
[89] *Compare* NHRCA, *supra* note 44, art. 20(3) and NHRCA, *supra* note 44, art. 25(3) (failure to implement a Commission recommendation must be justified in writing to the Commission).
[90] NHRCA, *supra* note 44, art. 25(1). Note that the agency must "endeavor to implement" the recommendations, implying something less than a hard duty and something more than a hortatory obligation to simply take notice. NHRCA, *supra* note 44, art. 25(2).
[91] NHRCA, *supra* note 44, art. 25(3).
[92] NHRCA, *supra* note 44, art. 22(1), (3).
[93] NHRCA, *supra* note 44, art. 23.

Analysis

On the whole, the Commission's institutional role as advisor and advocate for improving human rights is theoretically broad enough to enable it to both uncover information and to provide advice to the National Assembly and the bureaucracy. While not supported by compulsory powers, its ability to publicize its findings enables it to attract public scrutiny that can in turn bring pressure upon the government to act. Additionally, government agency obligations to contact the Commission on human rights issues are an important provision to ensure positive action by the bureaucracy.

However, no information available in English stipulates how an agency is to determine when notification is required, nor what disciplinary measures, if any, exist for failure to contact the Commission. As a result, the Commission must likely rely on bureaucratic willingness to share information, both in terms of proactively doing so, and in responding to the Commission requests. Such a situation enables government agencies to effectively stonewall investigations, and encourages the Commission to prioritize its investigations by the level of governmental cooperation it can obtain rather than on the importance of the issue to advancing and protecting human rights. This state of affairs constitutes a subtle threat to the Commission's independence, as obstinate agencies can simply refuse to provide information, and can further fight requests to cooperate. The latter challenge is offset to an extent by the Commission's power to publicize refusals and thus draw media and civil society attention.[94] In the best cases, the threat of publication can pressure agencies to carefully consider the Commission's recommendations rather than simply dismissing them out of hand.[95]

Recommendations

Reducing government actors' ability to refuse to cooperate is a priority in ensuring that the NHRCK can carry out its work. Legal amendments in this area should include:

1. Eliminating the current ambiguity over when a government agency must notify the

[94] This power is of course dependent on mass media and civil society responding to such publications.

[95] The Commission's lack of expertise on non-human rights issues makes it difficult to argue that agencies should always have to follow the Commission's advice. While an appeal procedure could be put in place as a safeguard, recalcitrant agencies could simply file appeals to every part of a recommendation, effectively preventing compliance for long periods of time while simultaneously taxing the Commission's resources through adjudication proceedings.

NHRCK.

2. Providing guidelines on what constitutes a "justifiable reason" for a government agency refusing to respond, and requiring the agency to send a written explanation to the Commission.

Clear guidelines that detail when a government agency must notify the NHRCK, and a clear decision-making process involving staff of appropriate seniority, should be promulgated. While it will not entirely obviate resistance from agencies hostile to the Commission, it will help ensure that they have less leeway in deciding when and when not to communicate with the NHRCK.

Secondly, the currently vague "justifiable reason" language undermines the Commission's independence by letting agencies determine what constitutes such a reason. A clear definition of the above term, coupled with a mandate to provide written justifications for refusing consultation requests, as are currently required when refusing NHRCK recommendations, would provide stronger legal imperatives for agency cooperation. The feasibility of statutory deadlines for agency responses, and whether the ability to sue to compel obstinate agencies to respond exists in current law, deserves further research, as it may also help deter the bureaucracy from stonewalling investigations.[96]

2. INVESTIGATING AND ADJUDICATING INDIVIDUAL COMPLAINTS

Individuals who believe that government has violated their Constitutional human rights[97] or who have faced discriminations from *either* governmental or private organizations,[98] may petition the NHRCK to investigate the matter with an adjudicated outcome possible. The process that the NHRCA establishes is fairly robust, but as will be shown, is engaged largely at the discretion of the Commissioners.

In contrast to its research and advisory roles, the NHRCA empowers the Commission to

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[96] Understanding that suits compelling action would be expensive and time consuming, and may thus not be practically feasible even if they are legally so.

[97] NHRCA, *supra* note 44, art. 30(1)(1). Government organs include both those at national and local levels. Note that the scope of valid petitions is narrower than the Commission's mandate; neither international law nor national legislation is included. In the latter case, however, a petitioner may be able to allege that a piece of legislation or regulation contravenes Constitutional human rights protections. *Id.*

[98] Private entities are called "juristic persons" in the English translation. *See* NHRCA, *supra* note 44, art. 30(1), (2). The Commission may also conduct *ex officio* investigations when there is a reasonable belief that serious human rights violations or discrimination have taken place. NHRCA, *supra* note 44, art. 30(3).

compel cooperation in many instances. For example, when investigating complaints, the Commission can order statements from the petitioner, the respondent, and all interested parties. With some limitations, it can also order these parties to appear before the Commission and give testimony.[99] It can further compel concerned parties, including government agencies, to submit materials the Commission deems necessary to the investigation,[100] and it can even conduct "on the spot" inspections as necessary.[101] Requests for materials or inspections can be refused only when issues of national security, "diplomatic relations," or serious impediments to ongoing criminal investigations or pending trials are implicated.[102] Those refusing to cooperate with a Commission investigation as required can face fines of up to 10 million Korean Won (about US$9,000).[103] Obstructing the Commission's duties "by any deceit," destruction or falsification of evidence, or intimidating Commissioners or their staff through threat or force carries a prison term of up to 5 years or a fine of up to 30 million Won (about US$27,000).[104]

In resolving cases, the Commission can establish a "conciliation committee"[105] to either negotiate a resolution between the petitioner and the respondent, or, should parties fail to come to an agreement, to render a decision to "fairly settle the case."[106] Decisions can include halting the acts that led to the violation,[107] recovery and/or compensation for damages, "other necessary remedies,"[108] and/or any measure to prevent reoccurrence of the violation.[109] Failure to file a complaint within two weeks of a decision constitutes the party's acceptance

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[99] NHRCA, *supra* note 44, art. 36(1)(1). Although not clearly worded, respondents are required to appear only when 1) their statement does not provide sufficient information to judge the veracity of the petitioner's claim, 2) the respondent is an individual accused of direct responsibility and 3) reasonable grounds exist to determine that the human rights violation *and* discriminatory act pursuant to art. 30(1) have occurred. The "and" immediately prior to the third prong implies that both a violation and discrimination must have occurred.

[100] NHRCA, *supra* note 44, art. 36(1), (2).

[101] NHRCA, *supra* note 44, art. 36(1), (3). Commissioners can directly conduct on the spot investigations and require testimony from relevant individuals on the site. NHRCA, *supra* note 44, art. 36(1), (4).

[102] NHRCA, *supra* note 44, art. 36(7)(1), (7)(2).

[103] The fine is set at up to 10 million Korean Won. NHRCA, *supra* note 44, art. 63(1). Amount in US dollars based on an exchange rate of 1,111.26 Won = US$1 as of Oct. 13, 2012. *See* Bloomberg, http://www.bloomberg.com/markets/currencies/asia-pacific.

[104] 30 million Korean Won. NHRCA, *supra* note 44, art. 56(1). *See* Bloomberg, http://www.bloomberg.com/markets/currencies/asia-pacific.

[105] The scope and nature of conciliation committees are beyond the scope of this article. *See* NHRCA, *supra* note 44, arts. 41-42.

[106] NHRCA, *supra* note 44, art. 42(3).

[107] NHRCA, *supra* note 44, art. 42(4)(1).

[108] NHRCA, *supra* note 44, art. 42(4)(2).

[109] NHRCA, *supra* note 44, art. 42(4)(3).

of that complaint.[110] Both successful conciliations, as well as the Committee decisions rendered when conciliation fails, have the force of a settlement in court.[111] Where a human rights violation or an act of discrimination is found, the Commission may recommend disciplinary action to the head of the institution(s) that the individual(s) work at.[112] Should the investigation uncover potential criminal liability, the Commission can file a complaint with the appropriate investigatory body.[113]

Finally, on the individual level, the Commission's binding quasi-judicial decisions give its determinations the force of law, providing individuals with an actual opportunity to seek redress, either in terms of a compromise or an adjudicated outcome.

Analysis

Overall, the Commission's investigatory authority would seem to fit within the guideline of the Paris Principles' directive for adequate powers of investigation.[114] In fact, the Commission's powers in this area appear to be fairly well supported with binding force. Justified refusals to cooperate are based on seemingly narrow grounds. However, those grounds could most easily be over-used by the military, police, and prosecutors,[115] the very groups that are empowered to use (and thus possibly abuse) the government's monopoly on force.[116] Although hopefully never reaching the level of human rights violations perpetrated by previous authoritarian regimes in Korea,[117] the national security exemption is ripe for abuse.

These limitations notwithstanding, penalties for non-cooperation, although somewhat light for those simply refusing a request by the panel, can be severe for more pernicious attempts at obstructing the Commission, signaling that proper requests are to be taken

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[110] NHRCA, *supra* note 44, art. 42(6). Note that complaint procedures are not stipulated in the Act.
[111] NHRCA, *supra* note 44, art. 43. It is assumed that an outcome with such binding force would be recognized and enforced in court should the losing party fail to honor a negotiated compromise or the Committee's decision.
[112] NHRCA, *supra* note 44, art. 45(2). The provision is silent on what an agency receiving such a recommendation must do. On the face of the law, the recommendation appears hortatory.
[113] NHRCA, *supra* note 44, art. 45(1).
[114] *See* Guidelines for the Paris Principles, *supra* note 34, at 31.
[115] *See* NHRCA, *supra* note 44, art. 36(7)(1), (7)(2).
[116] The Commission's refusal to probe a military whistleblower case provides a key example of how restrictions on its investigatory powers hamper its effectiveness in an area where the agency's vigilance against human rights abuses is sorely needed. *See* Lee Hyo-Sik, *Rights Panel Not to Probe 'Military Whistleblower' Case*, THE KOREA TIMES, Mar. 4, 2012.
[117] The Gwangju massacre would be but one example. *See e.g.,* James M. West, *Martial Lawlessness: The Legal Aftermath of Kwangju*, 6 PAC. RIM L. & POL'Y J. 85, 93-96 (1997).

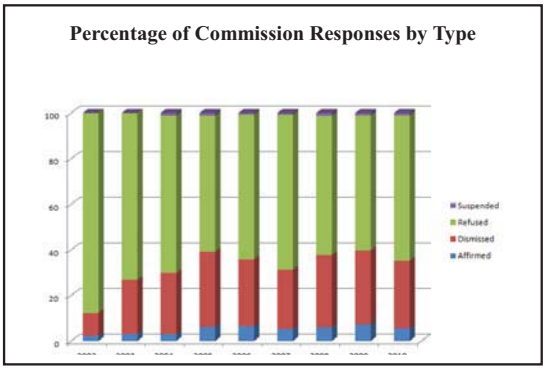
seriously.

That said, an examination of the application of these penalties will be important in assessing how effective they have been as a deterrent to non-cooperation. Significantly, it is not clear from the NHRCA alone whether these penalties could be applied to individuals within the government who are found responsible for an agency's unjustified refusal to cooperate. The ability to simply stonewall investigations is in itself a threat to the Commission's independence, as it pressures the Commission to self-censor in order to secure government agencies' cooperation in carrying out investigations.

For all of the compulsory authority the Commission wields, however, the law gives it incredibly broad discretion over whether to investigate complaints of human rights violations. Aside from specific justified reasons, the Commission may also reject a petition it simply deems "improper to investigate."[118] Although the Commission must immediately provide an explanation to the petitioner for its rejection,[119] what defines "improper" is not at all clear. Such a vague term enables overly broad discretion in accepting cases, allowing political considerations to affect case management at the least, and permitting Commissioners loyal to the government to reject large swaths of politically damaging complaints at the worst. Furthermore, negative decisions carry no right of appeal, and are thus not automatically open to judicial scrutiny.[120] Alarmingly, petition statistics from 2002 to 2010 display an affirmation rate of only about 5%, as seen in the graphs below:[121]

Complaints of Civil Rights Violations by Resolution					
Year	**Affirmed**	**Dismissed**	**Refused**	**Suspended**	**Total**
2010	331	1831	3906	63	6131
2009	365	1637	2974	54	5030
2008	308	1644	3177	60	5189
2007	239	1215	3152	35	4641
2006	207	932	2020	21	3180
2005	244	1318	2378	45	3985
2004	145	1280	3306	52	4783
2003	94	717	2210	0	3021
2002	29	136	1174	0	1339

[118] NHRCA, *supra* note 44, art. 32(7).
[119] NHRCA, *supra* note 44, art. 32(4).
[120] A broader legal assessment of whether a petitioner would have standing to appeal a rejection to the court system is beyond the scope of this article, but the absence of such a mechanism in the NHRCK's enabling legislation is striking.
[121] Data in the following charts is drawn from NHRCK Annual Report, *supra* note *63*, at 71. Note that while the annual report refers to these as "civil rights" violations. Although the term is not defined in the report, statistics regarding violators cover only government agencies, implying that the term applies only to violations by government actors.



Note that the NHRCK annual report in 2010 claimed without explanation that dismissed cases were primarily composed of those withdrawn by the complainants, because "the complaints were resolved" or that "complainants were satisfied with the outcome."[122]

While much attention has focused on the Lee administration's attempts to hobble the Commission, an approximately 95% rejection or dismissal rate in the first nine years, which included Presidents who were friendly to the Commission, is suggestive of an agency whose independence from government influence is compromised to at least some extent. Such a high rate may be partially explained by the Commission's duty to respond to all requests, whether frivolous or beyond the Commission's mandate, but it should still raise calls for investigation into how the Commission decides whether or not to reject a case, and the grounds upon which it dismisses them.[123]

Finally, of the 1,962 cases affirmed for the petitioner between 2002 and 2010, only 160 cases have led to recommendations for criminal investigation or even disciplinary action.[124] Excepting those caused by government regulations or policies, human rights violations are otherwise caused by one or more individuals, meaning that a recognized violation should have led to a recommendation of at least disciplinary sanctions in many more cases. While a more thorough assessment of the case data behind the statistics is needed, the Commission

[122] NHRCK Annual Report, *supra* note *63*, at 72.

[123] Note that the rejection rate alone should not be used as a barometer of the Commission's effectiveness. Determining what the level of frivolous cases are (and indeed what constitutes a frivolous case!) are the more important questions. Still, a 95% rejection rate is more than sufficient justification to investigate when and why the NHRCK rejects a case.

[124] NHRCK Annual Report, *supra* note *63*, at 72. Discrimination complaints have fared somewhat better, with approximately 11% of cases reaching settlement or a recommendation from the Commission from 2002-10, and remaining around the 11% mark each year for 2008-2010. Out of approximately 8,666 cases, however, the Commission has recommended disciplinary action in only 3 cases. *Id.* at 88.

seems to be greatly underutilizing its powers to recommend sanctions or request criminal investigations.

Given the above statistics, attempts from various corners of the government to curb the Commission's investigatory powers during both friendly and hostile Presidential administrations cannot be ruled out. As the history of opposition to the Commission makes clear, the organization faces a less than supportive political environment. The agency's coercive powers are neither all-encompassing nor automatic, meaning that it must work to secure at least some degree of cooperation from the agencies it investigates. The discretion to reject cases could be a negotiating point, enabling the Commission to avoid cases that would damage its relationship with agencies and important actors within the government. This compromises the agency's ability to carry out its mandate and threatens victims' ability to obtain justice.

Recommendations

Revisions that cut down on the Commission's discretion to avoid acting would serve as a buffer against pressure from the government, while making it more difficult for hostile administrations to control the agency through sympathetic Commissioners. In particular legal revisions should:

1. Clarify the meaning of "improper to investigate."
2. Revisit the national security exemption.
3. Communicate to petitioners the reasons for rejections.
4. Create a right to appeal rejections.

The Commission requires the power to reject frivolous cases, but the term "improper to investigate" provides no clear boundaries. Guidelines delineating a transparent decision making process and specific criteria governing when to accept a case should be developed and communicated clearly. The national security exemption requires similar clarification, and must be particularly policed to ensure that the Commission does not cave to governmental pressure to invoke this exemption when it is inappropriate to do so. A written record of rejections would bring public scrutiny upon the organization's deliberation, making it less likely to bend to government pressure. As an additional check on the Commission's discretion, the ability to appeal would bring judicial scrutiny down upon the organization and would

enable a more objective development of the contours of what constitute meritorious cases.[125] Finally, case research could uncover more issues that should be addressed.

Ultimately, a balance must be struck between investigatory discretion to dismiss frivolous cases, and an imperative to follow through on meritorious ones. Where that balance lies will necessarily arise initially through legal amendments and then through the accumulation of case experience, both at the Commission level and through the courts.

In examining the NHRCA's operational provisions, the Commission's robust powers to compel government and even private entity action in investigating human rights violations theoretically give it the ability to carry out its mission with limited interference from or dependence on government cooperation. At the same time, the NHRCK has very broad discretion in deciding when to pursue its duties. Legislative language defining the contours and limits of the Commission's discretionary power would help ensure that the organization would be required to act in certain circumstances, regardless of how friendly Commissioners are to the government. Indeed, such guidelines, coupled with greater reporting requirements, would increase outside scrutiny on the organization to ensure it carries out its duties, making it less vulnerable to undue government influence.

IV. CONCLUSION

The short history of the NHRCK shows an organization working in an environment of sharp political conflict that has shown no sign of subsiding. While receiving early commendation for its independence and effectiveness relative to similar institutions in other parts of Asia, both domestic and international observers have come to criticize it as a compromised entity, thanks to the actions of a hostile presidential administration.

The Commission's legal structure echoes this narrative of compromised independence. While largely following the Paris Principles' general guidelines for an agency with a broad mandate, official independence, and ability to carry out investigations, key vulnerabilities in both its structural and operational provisions undermine the organization's ability to carry out its mission.

Structurally, the Commission enjoys a broad mandate that prevents governmental agencies from declaring parts of their activities off-limits to the NHRCK. However, a lack of

[125] Although costs to the court system could be significant, given the current petition rejection rate, *Cf.* NHRCK Annual Report, *supra* note *63*, at 71.

interpretational guidelines enables the Commission to cabin off issues it does not wish to address. Presidential control over the CP's selection and retention can especially hinder the organization even during friendly administrations, as issues of loyalty and the implied threat of non-reappointment can influence the Commission's leader and all members generally. Shifting CP selection to Commissioners and doing away with reappointment while lengthening the term of service can help address these particular weaknesses. The budget is another key area of concern, as it is controlled by a governmental ministry. The President's direct authority over the Ministry of Justice, and thus the NHRCK's budgetary requests, provides a real and substantial point of influence. Empowering the NHRCK to compile and present its own budget to the National Assembly would sever the Commission's conflicting relationship with the Ministry.

In carrying out its mandate, the Commission's research and advisory functions are supplemented with limited but insufficient requirements that government agencies cooperate. Practically, the Commission must rely on bureaucratic cooperation to carry out these functions, making it susceptible to pressure against investigating issues that government actors want left untouched. Requiring specific timelines for agencies to respond to the Commission requests, clarifying when agencies can refuse to cooperate, and mandating that they publish reasons for non-cooperation would strengthen the bureaucracy's duty to respond to the Commission.

In investigating human rights complaints, the Commission enjoys a broad array of compulsory powers, supported by fines and even criminal penalties for particularly egregious attempts to halt an investigation. However, incredibly broad discretion in rejecting petitions the Commission deems "inappropriate" is a very practical point of vulnerability to government influence. Commissioners friendly to the government can use this discretion to sidestep investigating embarrassing issues, and it enables the Commission to bargain away investigations in return for increased bureaucratic cooperation elsewhere. The high percentage of rejected or dismissed petitions, coupled with an equally low rate of sanctions and criminal investigation referrals, strongly hint at direct or indirect influence over the organization.

The common thread connecting both the structural and operational aspects of the NHRCA is the issue of discretion. Whether influenced directly by friendly political appointees, or bending to the realities of political bargaining in order to secure bureaucratic cooperation, the high level of discretion afforded the Commission in exercising most of its powers is ripe for abuse. Clearly setting the contours and limits of its discretionary powers

will be vital to ensuring that the organization is less directly influenced through appointees, and that it is less susceptible generally to pressure from the government.

On the whole, the NHRCK's foundational law reflects the conflict played out on the political stage. Although having received little attention, the flaws in the NHRCA are a critical factor preventing the agency from operating independently and effectively, especially when a hostile administration is in power. Achieving the necessary statutory changes discussed will require concerted effort by the public to overcome conservative and bureaucratic opposition, and must be followed up with public scrutiny to ensure that the NHRCK fully engages its powers to protect and advance human rights. At the end of the day, statutory revisions are critical, but they alone are not sufficient. They must be matched with public pressure and lasting political will to ensure that the Commission fully lives up to its mandate as an independent advocate within the government for human rights.

Keywords

Human Rights, Korea, National Human Rights Institutions

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JAPANESE CORPORATE GOVERNANCE: INSIGHTS FROM THE UNSUCCESSFUL ADOPTION OF THE AMERICAN MODEL

Caslav Pejovic[*]

ABSTRACT

Corporate governance may be analyzed from different perspectives, one of them being its legal aspect. Instead of examining legal norms that regulate corporate governance, this paper analyzes the relationship between non-legal norms and corporate governance focusing on the influence that non-legal norms have on the way corporate governance functions in Japan. The objective of this paper is to examine the reasons for deviations from the American corporate governance that has been used as a model in the postwar period in Japan. This research belongs, in fact, to the area of Comparative Law, as it relates to the issue of legal transplants, and to the issue of world legal cultures. The Japanese corporate governance is used mainly as a case study. The goal of research is wider than simply analyzing the Japanese corporate governance; it is hoped that the results of research will be applicable to other segments of the Japanese legal system and be helpful in analyzing the role of both legal and non-legal norms in the Japanese society. Further goal is to explore the need for giving more attention to the law and society, and to the inter-disciplinary approach in the legal research. By exploring new research agendas the research horizon can be expanded, and it is hoped that this paper may contribute to achieving that goal.

I. INTRODUCTION

Japanese corporate governance has often been the subject of attention of foreign scholars, particularly in debates on the comparative aspects of corporate governance.[1] Such interest is logical, Japan being one of the world's largest economies. Additionally, Japanese corporate law has come under the influence of both the civil law and the common law, and both of them

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[1] For a comprehensive review of this literature, *see* Luke Nottage, *Perspectives and Approaches: A Framework for Comparing Japanese Corporate Governance*, *in* CORPORATE GOVERNANCE IN THE 21ST CENTURY JAPAN'S GRADUAL TRANSFORMATION 21, 21-52 (Luke Nottage, Leon Wolff & Kent Anderson eds., Edward Elgar Publishing 2008).

mixed with Japan's specific legal culture make the Japanese model of corporate governance an interesting subject for comparative corporate governance scholars.

Even though in the postwar period Japan adopted corporate governance structures and rules based on American corporate law, the way Japanese corporate governance functioned in practice deviated substantially from the American model. First objective of this paper is to explain the reasons for the failed adoption of the American model in Japan, which may also facilitate a better understanding of the Japanese model. In a wider context, the goal of this paper is to contribute to a better understanding of corporate governance as a whole by illuminating the Pandora's Box that may be opened by transplanting ill-suited black letter corporate laws onto foreign soil. Second objective of the paper is to analyze various potential alternatives for the future development, including further convergence of the Japanese model on the "global standards," maintaining its distinctive features and a "third way" which would combine these two alternatives.

Recent reforms of the corporate governance in Japan following economic crises have raised several issues regarding direction of changes. In Japan there is a broad agreement on the need of changes, but there is a disagreement about the scope and goals of the changes. The paper will try to answer a number of related questions, such as: What is the nature and the scope of changes? What is the impact of recent reforms on corporate governance? Will or should Japan converge on the American model? How can be reconciled reforms focusing on protection of shareholders in a dominantly stakeholder model: is greater protection of shareholders given at expense of some stakeholders, particularly employees? What is the prospect of creating a hybrid model? Various possible scenarios will be examined in order to draw conclusions on the nature, scope and direction of changes of the Japanese corporate governance in the coming years.

The paper will firstly introduce the process of the adoption of the American model into Japan in the post-war period and the main features of Japanese corporate governance. The paper will then examine causes for the deviations of the Japanese system from the U.S. model. Particular attention will be given to non-legal norms and their impact on the corporate governance in Japan. Potential for greater convergence of Japanese corporate governance in the future will be explored by examining barriers to convergence, as well as the factors that may contribute to it. The last part will evaluate various possible alternatives for the corporate governance in Japan in the future.

II. ADOPTION OF THE AMERICAN MODEL

After Japan opened its doors to the outside world in the mid-19th century, it embarked on a process of modernization. As a part of this process, Japan undertook a comprehensive revision of the legal system during the *Meiji* period by adopting Western legal institutions. However, only the legal form was adopted from the West, while the way of doing things maintained a distinctive Japanese flavor. This was a part of the strategy to preserve its own values while importing Western technology under the slogan 'Japanese spirit, Western skills' (*wakon yosai*). This approach has been maintained to the present day with some variations. Being aware of the existence of such an approach is important for understanding the way the foreign models have been adopted in Japan and the reasons behind adopting only the form, while the practice is often very different. As a result, the legal institutions adopted from the West have not operated in Japan in the same manner as they do in the West.

The Japanese legal system is based on legal transplants originally imported from Germany.[2] However, in the post-war period, particularly in the area of corporate law, Japanese law made a distinct move towards the American model.[3] The genesis of the Americanization of Japanese corporate law came during the occupation period, when American law heavily influenced major revisions to Japan's black letter corporate law—which were aimed at implementing a U.S.-style shareholder primacy model. American influence was also dominant after the economic "bubble burst" in the 1990's.[4] In Japan's post-bubble era, discussions surrounding a new approach to corporate governance often gravitated towards the need to adopt "global standards" in corporate governance reforms. The idea of adopting "global standards" was typically understood as a thinly veiled disguise for adopting American standards.[5]

In practice, the Japanese model has deviated substantially from the American one.[6] The

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[2] There are several reasons for the choice of German law, related to suitability for Japan. *See* HIROSHI ODA, JAPANESE LAW, 27-29 (Butterworths 1992).

[3] Hiroko Aoki, *Revisions of Corporate Law*, 6 J. JAPAN. L. 97, 99 (2001).

[4] *Id.* at 101.

[5] Christina Ahmadjian, *Changing Japanese Corporate Governance*, *in* JAPAN'S MANAGED GLOBALIZATION: ADAPTING TO THE TWENTY-FIRST CENTURY 222, 222 (Ulrike Schaede & William W. Grimes eds., East Gate Book 2002).

[6] For an explanation of how the corporate law provisions in the *Commercial Code* were redrafted during the American occupation period to reflect U.S. corporate law, *see* Thomas L. Blakemore & Makoto Yazawa, *Japanese Commercial Code Revisions: Concerning Corporations*, 2 AM. J. COMP. L. 12 (1953). For an explanation of the significant gap between the US-style corporate law in Japan's *Commercial Code* and its application in practice, *see* Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions*, 25 DEL. J. CORP. L. 189

main bank system, cross-shareholding, as well as the long-term employment system, all developed in the post-war period when Japan was supposedly following the American model. Each of these essential features of the Japanese corporate governance model is in clear contrast to the American model. One of the paradoxes of the Japanese model is that during the period when the model was presumably under the influence of American-style black letter corporate law, it actually diverged from the American model. Some commentators have described this divergence as a puzzle.[7] This text will attempt to find answers to this puzzle.

III. MAIN FEATURES OF THE TRADITIONAL MODEL

Corporate governance may be classified by using different criteria: the social role of corporations, ownership structure, models of monitoring, the differing nature of legal systems and so on. In such classifications, typically a distinction is made between the common law and the civil law models. The common law model is based on dispersed shareholding, strong protection of shareholders, important role played by independent directors and institutional shareholders, and a well developed market for corporate control. On the other hand, the civil law model is based on protection of stakeholders, more concentrated shareholdings, a strong role played by the banks and other financial institutions, and a rather weak market for corporate control.

The Japanese model of corporate governance, on its surface, resembles many other models. Although there are several differences between the models of corporate governance of the United States and Japan, they still maintain the same basic structure. According to one leading Japanese legal scholar, Japanese law more closely resembles the Anglo-Saxon shareholder-value model than the stakeholder model.[8] However, this similarity is just in form. Behind the façade of legal norms that purport to regulate corporate governance, there exists the real world of corporate governance which is governed not only by legal norms, but also by non-legal norms that are in many respects far more important.[9]

(2000).

[7] Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States*, 150 U. PA. L. REV. 527 (2001).

[8] Takashi Araki, *Changing Employment Practices, Corporate Governance, and the Role of Labor Law in Japan*, 28 COMP. LAB. L. & POL'Y J. 251, 263 (2007).

[9] Author has analyzed the impact of non-legal norms on Japanese corporate governance in detail in, Caslav Pejovic, *Japanese Corporate Governance: Behind legal Norms*, PENN ST. INT'L. L. REV. 483 (2011).

While the legal form of corporate governance in Japan is more similar to the common law 'shareholders' model, a number of its features are closer to the civil law 'stakeholders' model. The most typical features of the traditional Japanese model include: the main bank system, cross-shareholding, and long-term employment.[10] The close relationship between the business elite and the government may also be added to this list.

A. CROSS-SHAREHOLDING

The structure of a large publicly traded company is traditionally characterized by cross-shareholding (*keiretsu*), referring to mutual shareholding through which a number of companies are interconnected in a network where each of them holds shares in the other companies.[11] In addition, the shares are also held by banks, life insurance companies, individual shareholders and foreign investors.

The beginning of the process of creating *keiretsu* goes back to 1960's. After the initial period in the 1950's, when the Anti-Monopoly Act of 1947 prohibited stockholding by companies, things radically changed in the 1960's. Japan became a member of the OECD in 1964, and one of the conditions for membership was the deregulation of its financial market. As the government relaxed the entry of foreign capital into the country, there was a growing concern about possible takeovers of Japanese companies by foreign companies. As a response to the liberalization of the country's markets, large Japanese corporations created a defense mechanism by establishing a stable shareholding system with the participation of "friendly companies."[12] Following these changes, the Commercial Code was revised to allow the

[10] There is a general consensus in the literature that the main bank, *keiretsu* and lifetime employment were the three central features of Japan's post-war system of corporate governance. However, two of the most prominent Japanese corporate governance scholars, Yoshiro Miwa and Mark Ramseyer have recently published numerous articles and a book which suggest that all of the central features of Japanese corporate governance are "academic myths" (i.e., they do not exist). For an example, *see* YOSHIRO MIWA & J. MARK RAMSEYER, THE FABLE OF KEIRETSU (U. Chi. Press 2006); Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC. INQUIRE 401 (2002). For a critique of Miwa and Ramseyer's contrarian research—which also supports the general view taken in this paper that the central features of Japanese corporate governance do indeed exist—*see,* Dan W. Puchniak, *A Skeptic's Guide to Miwa and Ramseyer's 'The Fable of the Keiretsu,'* 12 J. JAPAN. L. 273 (2007); Dan W. Puchniak, *Perverse Main Bank Rescue in the Lost Decade: Proof that Unique Institutional Incentives Drive Japanese Corporate Governance*, 16 PAC. RIM L. & POL'Y 13 (2007).

[11] *Keiretsu* is the term usually used in the English literature to denote cross-shareholding. In Japanese, cross-shareholding is usually called "*mochiai"* or "*kabushiki mochiai,"* while the term *"keiretsu"* usually refers to the network of companies.

[12] Takashi Araki, *Corporate Governance Reforms and Labor and Employment Relations in Japan: Whither Japan's practice-dependent Shareholder Model?*, 1 U. TOKYO J.L. & POL. 45, 50 (2004).

issuance of new shares to companies, leading to the concentration of shareholdings in the hands of banks and corporations and the creation of *keiretsu,* which contributed to the relatively stable and concentrated ownership structure of Japanese companies. Logically, this resulted in a substantial reduction of individual shareholdings as the shares became concentrated in a small group of financial organizations and corporations. Thus, the *keiretsu* was made possible by government action which was behind the regulations allowing shareholdings by companies.

Keiretsu literally means "economic line-ups" and includes something more than what is just covered by the concept of cross-shareholding. *Keiretsu* is a structural arrangement of Japanese firms characterized by close business relationships intertwined with long-term commitments among members. There are various types of *keiretsu*, but the main type is the *keiretsu* corporate group (sometimes called *"gurupu"*), with the main bank at the center.[13]

Banks used to have shares in their client companies as a part of a broader relationship that involved the management of financial transactions, while corporations held shares of their suppliers and clients as a part of their business strategy and cooperation. This pattern was well suited to the Japanese version of capitalism, which relied on stable purchase-supply transactions and lending sources, as well as lifetime employment. This also makes sense from the perspective of government policy, since the goal is to enable companies to get capital at an affordable price and therefore be able to make long-term strategic decisions, while maintaining a high level of employment.

Typically the shares held under these ongoing stable shareholding arrangements constitute the controlling portion of the firm's shares.[14] There is a mutual understanding between the companies that these shares are not to be traded, but to be kept as a safety mechanism.[15] Member companies within a *keiretsu* offer each other preferential treatment in commercial and financial transactions. They may exchange information and, in times of crisis, they are expected to help each other. Long-term policy is one of the fundamental values of Japanese corporate governance. The creation of the cross shareholding system enabled the managers of Japanese companies to pursue long term business strategies.

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[13] Six major *keiretsu* groups are Mitsui, Mitsubishi, Sumitomo, Fuyo, Dai Ichi Kingyo and Sanwa.

[14] For an explanation of the efficiency of the *keiretsu* system, *see* Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993).

[15] In Japan, a distinction is made between investment shareholding and stable (mutual) shareholding (*antei kabunishi*). The first one involves trading on the stock market, while the second means that shares are not traded but are used to cement the relationship and prevent takeovers.

B. MAIN BANK

The main bank system is one of the major characteristics of the Japanese corporate system. The main bank system may have originated in the pre-war period in the wartime directives issued by the Ministry of Finance. In the post-war period, the main bank system developed due to the close relationships the banks developed with their company clients. In contrast to the U.S. where banks are explicitly prohibited from holding shares of other companies,[16] in Japan banks can own up to 5% of the shares of other companies.[17] This gave the banks deep insights into their client company's business and performance, as well as access to information about the financial health of the companies.

The main bank plays an important role in monitoring the company's management and is expected to intervene when things go wrong.[18] Bank participation in the monitoring process was made possible not only by their access to the relevant information, but also due to the leverage the banks have due to their substantial shareholding and debt and equity positions with client companies. As the largest creditor and an important shareholder the main bank has a legitimate interest in ensuring the proper management of the company.

The banks are in a position to influence management and they may intervene in times of crisis in a company, because they have at stake not only their money as lender and shareholder, but also at risk is the loss of their client and reputation. In a time of crisis, the main bank takes responsibility for rendering assistance, which may include such measures as the rescheduling of loan payments, or the granting of new loans, etc. The main bank may also take active role in the management of the companies, placing the bank's personnel on the company's board. Because management is often replaced in this reshuffling of the board, the main bank system is said to substitute for the missing takeover market in Japan.[19]

C. LONG-TERM EMPLOYMENT

Long-term employment is another typical feature of the Japanese model. Under this system, an employee is recruited directly from school or university and is expected to remain

[16] The Banking Act, Pub. L. 73-66, 48 Stat. 162 (June 16, 1933) (known as "Glass-Steagal Act").
[17] Securities and Exchange Act, 15 U.S.C. § 78a, art. 65 (1934); The Antimonopoly Act, Act No. 54 of 1947, art. 11 (Japan).
[18] Masahiko Aoki**,** Hugh Patrick & Paul Sheard**,** *The Japanese Main Bank System: An Introductory Overview, in* THE JAPANESE MAIN BANK SYSTEM 3-5 (Masahiko Aoki and Hugh Patrick eds., Clarendon Press, Oxford 1994).
[19] *Id.* at 3.

in the company's employ for the length of his or her career. In return, he or she can expect not to be fired or discharged, except under some extraordinary circumstances.[20] The basis of this agreement is the commitment of employers to provide secure employment to their employees in return for loyalty and "lifetime" service. As a part of this system, the promotion of employees within the hierarchy of the company and the wages paid are based on the principle of seniority.[21] The mandatory retirement (*teinen*) system is an essential element of long-term employment.

The origins of the long-term employment concept date from the early part of 20th century, when it gradually developed as a business strategy to avoid the high fluctuation of workers that created difficulties for companies, particularly in key industries such as iron and steel.[22] To solve that problem, companies started to offer incentives designed to encourage experienced workers to stay, such as increased wages based on seniority and hefty retirement allowances for long-term workers.[23] An ideological justification for the long-term employment relationship developed afterwards, tying it to Confucian notions of reciprocal obligations. At the start, however, long-term employment was, in fact, a new strategy based on rational economic choice by employers.[24] The system was first institutionalized only in the 1950's and became popular in the 1970's.[25] The modern long-term employment system was allegedly designed as a result of a compromise entered into between management and unions aimed at overcoming existing labor problems, being a mutually beneficial bargain rather than as a solution imposed by social norms.[26]

Long-term employment does not mean a formal obligation of the company not to dismiss its employees, nor does it mean that the company does not dismiss employees as this

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[20] JAMES C. ABEGGLEN & GEORGE STALK JR., KAISHA – THE JAPANESE CORPORATION, 183-88, 191-92, 194-206 (Charles E. Tuttle Company, Tokyo 1985); *see also* Takashi Araki, *supra* note 12, 251-52; Roland Gilson & Mark Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance*, 99 COLUM. L. REV. 508 (1999).

[21] John O. Haley, a leading Japanese law scholar, has recently expressed the view that Japan's long-term employment system is *the* critical feature that defines Japanese corporate governance and makes it unique from other systems of corporate governance around the world. John O. Haley, *Career Employment, Corporate Governance and Japanese Exceptionalism* (Faculty Working Paper Series, Paper No. 04-04-01, 2004).

[22] Reiko Okayama, *Industrial Relations in Great Britain and Japan from the 1880s to the 1920s*, *in* LABOR AND MANAGEMENT, THE INTERNATIONAL CONFERENCE ON BUSINESS HISTORY 207, 227 (Keiichiro Nakagawa ed. 1979).

[23] KOJI TAIRA, ECONOMIC DEVELOPMENT AND LABOUR MARKET IN JAPAN 153-160 (Colum. Univ. Press, New York 1970).

[24] *Id.* at 159-60.

[25] *Id.* at 159-60.

[26] MASAHIKO AOKI, INFORMATION, INCENTIVES AND BARGAINING IN THE JAPANESE ECONOMY 116-119 (Cambridge Univ. Press 1988).

happens in practice. Rather, long-term employment is understood in the sense that the company will not resort to layoffs unless it is in deep economic crisis and layoffs are the only possible way to keep the company afloat and prevent bankruptcy.[27] Even in times of crisis, such as the oil shock crises, or more recently in the time of the so-called "lost decade," companies used other mechanisms aimed at avoiding layoffs, such as the reduction of overtime and assigning employees to affiliated companies.

The Japanese courts developed the doctrine of abusive dismissal to support long-term employment. According to this doctrine, a dismissal will be considered abusive if it lacks objectively rational grounds and is considered socially inappropriate. This legal doctrine has been present in a number of cases, starting in the 1950's, that have restricted the employer's power to dismiss employees.[28]

Long-term employment, in the sense of spending one's whole career in the same company, is not really unique to Japan since such patterns exist in many other countries, as well. However, relying on the numbers and statistics to prove that the Japanese model is not different from other long-term employment patterns misses the point. The essence of the Japanese model of long-term employment is not in the numbers, but in its character. There are several features of the long-term employment system that are typical for Japan, such as the way of recruiting graduates,[29] seniority-based wages, internal transfers based on a rotation system and on-the-job training, which result in firm-specific skills making it extremely difficult for employees to move to other firms. These features make Japanese long-term employment qualitatively different from the corresponding patterns in most other countries.

D. ROLE OF THE GOVERNMENT

The Japanese economic model has been described as a 'developmental state.'[30] The government plays important role in designing industrial policy to ensure national competiveness abroad and fair competition at home. It is similar, to a certain extent, to a

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[27] Leon Wolf, *The Death of Lifelong Employment in Japan?*, *in* CORPORATE GOVERNANCE IN THE 21ST CENTURY-JAPAN'S GRADUAL TRANSFORMATION 53, 77 (Luke Nottage, Leon Wolff & Kent Anderson eds., Edward Elgar Publishing 2008).

[28] Nagoya Chihō Saibansho [Nagoya Dis. Ct.] Dec. 4, 1951, 2-5 RŌMINSHŪ 578, 579 (Japan), quoted in TOMIO FUKUI, LABOR MANAGEMENT RELATIONS AND THE LAW IN JAPAN (1973); Tokyo Chihō [Tokyo Dis. Ct.] May 8, 1950, 1-2 RŌMINSHŪ 230, 235-36 (Japan).

[29] Practice of simultaneous recruiting of new graduates (*shinsotsu-ikkatsu-saiyō*) and the way of applying for job by the students (*shûshoku katsudô)* seem to be unique to Japan and S. Korea.

[30] "Developmental state" is a term used by political economy scholars to refer to the phenomenon of state-led macroeconomic planning in East Asia in the late twentieth century.

planned economy, a kind of controlled capitalism with industrial policy as an important tool for directing development. State provided guidance and support for corporations and banks. The system of administrative guidance reduced risk by allowing companies only actions approved by the ministries, while his also limited freedom of companies to apply innovative strategies. Intervention of the state was given preference over free market and competition.

Some segments of the Japanese government, particularly the Ministry of Finance and the Ministry of Trade and Industry, play active roles in regulating and monitoring the Japanese corporate world. The Diet is considered to be an extension of the bureaucracy and Japan is sometimes referred to as a "government of administration" rather than a government of laws.[31]

The Japanese business system is based on a partnership between politicians, bureaucrats and businessmen, often termed the "Iron Triangle." Big business financed the political campaigns of the Liberal Democratic Party (LDP) members, who in turn drafted legislation that favored big business. Legislation was implemented by the bureaucracy, while big business provided lucrative post-retirement jobs to bureaucrats. This cooperation between the LDP, government and large business was based on informal linkages outside the system based on legal norms.

The Japanese government has been very successful in influencing private business through industrial policy, particularly through administrative guidelines. The government used administrative guidance to impose its policies on companies, offering incentives for those companies which comply and threatening administrative sanctions in case of non-compliance with its non-binding advice. The Administrative Procedure Act of 1993 imposed restrictions on the use of sanctions against parties that refuse to comply with administrative guidance.[32]

Another segment of government involvement is *the amakudari* (天下り - 'descent from heaven') system, which means the practice whereby Japanese senior bureaucrats retire to join organizations linked with or under the jurisdiction of their ministries or agencies. While the practice of government officials moving to the private sector is not unique to Japan, what is typical is that government bureaucrats seek employment in the private sector only upon their mandatory retirement from their government position. The *Amakudari* system serves different

[31] *See* CHALMERS JOHNSON, JAPAN: WHO GOVERNS? THE RISE OF DEVELOPMENTAL STATE 140 (W.W. Norton & Co. 1995).

[32] Ken Duck, *Now that the Fog Has Lifted: The Impact of Japan's Administrative Procedures Law on the Regulation of Industry and Market Governance*, 19 FORDHAM INT'L. L. J., 1686-1763 (1996).

goals: the government has an interest in ensuring that implementation of its regulations. The civil servants have their own interest in getting a lucrative position after the retirement. Corporations have also an interest as they can get access to information which otherwise may not be easily accessible. This also allows corporations to lobby for their interests with the government and get a favorable treatment. *Amakudari* binds together the government officials and large corporations, as the government officials have a personal stake and while serving in ministries will normally refrain from making decisions that may imperil their future as *amakudari*. In this way, the government bureaucrats are, in fact, integrated into the Japanese corporate world. This aspect is very important for the process of implementation of regulations based on the process of consultation and cooperation between the government and business.

IV. JAPANESE STAKEHOLDERS' MODEL

Despite its 'shareholder model' form adopted from the U.S., Japanese corporate governance is, in essence, much closer to the 'stakeholder model' with particular attention being given to the protection of employees. While capital is certainly important, the Japanese system gives greater importance to labor and the efforts of employees. The idea that companies should be managed dominantly in the interest of shareholders is in conflict with the prevailing understanding of the role of companies in Japan. According to a survey conducted in firms in a number of countries, in Japan 97% of respondents answered that the company belongs to all stakeholders, while only 3% answered that it belongs to shareholders. In the U.S. 24% replied that company belonged to stakeholders, while 76% felt that it belonged to shareholders.[33] As a result of such an approach, Japanese companies tend to give low dividends to their shareholders, as the growth of the company is given greater importance than the profit of shareholders. According to the same survey, in Japan 97% of respondents viewed job security as more important than dividends, while in the U.S. only 11% considered job security as more important and 89% viewed dividends as more important.[34] In fact, the company and its well-being is the central focus of the Japanese system, and the company comes before both shareholders and employees. So, maybe it is more accurate to say that the

[33] Masaru Yoshimori, *Whose Company is it? The Concept of Corporation in Japan and the West*, 28 (4) LONG RANGE PLANNING 33, 33-44 (1995).
[34] *Id.* at 33-44.

Japanese system is focused on the wellbeing of the company itself, rather than on the employees.

The view that the management in Japan does not serve the interests of shareholders is misplaced. In Japan the shareholders may have different interests in the company. On one side, there are shareholders who have interests which are typical for individual shareholders, such as dividends; on the other hand, there is a different sort of shareholders who have interests that are often contrary to those typical interests of shareholders.[35] These interests may be the interests of a lender, employee, supplier, or customer, and they are more interested in the repayment of loans and stable profits, than in their dividends. In case of cross-shareholding, the main interests of shareholders relate to their stable business relationships. To summarize, the Japanese model can't be put decisively in either the shareholders' or stakeholders' model; it is a kind of mixed model which contains features of both main models. After all, the division between the 'stakeholders' and 'shareholders' models itself may not be fully appropriate, since the shareholders are, in fact, the most important stakeholders.

V. OWNERSHIP AND CONTROL

The separation of ownership and control which plays the key role in the U.S. model is not present in the same way in Japan. In Japan there is some ambiguity with respect to the ownership of companies. The prevailing view is that the company 'belongs to employees.' This is in clear contrast with the U.S., where there is a dominant view that companies belong to shareholders.[36] This difference requires explanation.

The structure of shareholding in Japan is dominated by mutual ownership of shares among companies. The fact that most large Japanese companies are owned by other companies and banks, which are also owned not by the classic type of shareholders, but by other companies in the same *keiretsu* raises the question: who really owns these companies and banks? In the case of mutual ownership between companies where each of them owns shares in each other, it might be difficult to identify individual shareholders. Consequently, the control over the management is not exercised on the basis of ownership by individual shareholders, but on the basis of mutual ownership of shares by the legal entities. So, the management does not, in fact, represent shareholders in a classical sense, but it represents

[35] *See supra* note 15.
[36] Yoshimori, *supra* note 33, at 33-44.

companies which are stable shareholders. The structure is so complex that it might be very difficult to identify the ultimate owner of the company.

These differences in the nature and structure of shareholding naturally affect the control of corporations. The issue of agency costs is not as relevant in Japan as it is in the U.S. If the manager represents the individual shareholders, there might be a conflict between different ideas between them as to how the company should be managed, which represents the basis of the "agency costs" concept. But if the manager represents the company which has shares in another company of the same *keiretsu*, then it is far less likely that there can be such a dispute, because the company as such does not have its own will in the same sense as the individual shareholders have it. This is especially the case in cross-shareholding scheme, where the interests of shareholders are to certain extent intertwined and are very different from the interests of individual shareholders.

Whose interests then represent the managers in the BOD? It can be argued that they are employees with a supervisory function. However, if the monitoring is performed by employees, this does not have to mean that those employees are representatives of employees. The management is not really selected by the employees, but by shareholders at the meeting of shareholders, so it is difficult to argue that the managers are representatives of employees. But then, the majority shareholders are companies controlled by other companies and each of those companies is, in fact, controlled by the managers who are at the same time employees. In the end, it seems that the main beneficiaries of the Japanese model are the elite permanent employees: the managers.

In a sense, private ownership as an essential ingredient of capitalism is lacking in the Japanese model. If the private capital is not the dominant factor in organizing the economy, the employees play a more important role than the shareholders, and the prevailing view is that the company "belongs" to the employees, then what kind of capitalism is that? Obviously, it is not the same as in the U.S.

VI. ROLE OF NON-LEGAL NORMS[37]

The question which has not been sufficiently explored is: in what way do non-legal norms influence the Japanese corporate governance system? Despite various debates on

[37] In the context of this text, the term "non-legal norms" is understood as rules that evolved through a social custom or tradition without being recognized as legal rules by formal institutions.

Japanese corporate governance, there have been remarkably few analyses of the link between non-legal norms and the way of functioning of corporate governance.

The corporate governance should be considered in the context of Japanese environment that goes beyond formal legal norms. There are various non-legal norms that operate in parallel to the legal norms and jointly determine the way of functioning of corporate governance. For a thorough understanding of the Japanese corporate governance system, it is critical to understand the way in which those non-legal norms impact the practice of corporate governance.

Legal systems are embedded in the social, economic and political life of a society, and are naturally influenced by the culture, history and tradition.[38] What is typical of Japan is a complex interplay of traditional and modern values, which often leads to original solutions based on both these influences.[39] Non-legal norms often play a more significant role in Japanese corporate governance than formal legal rules.[40] They are behind all of the key features of the Japanese model, such as *keiretsu*, the main bank system, long-term employment and the role of the government. These features are linked by the idea of cooperation and working together on the basis of trust rather than on the basis of legal commitments. *Keiretsu* and the main bank system are not an explicit organizational form, nor are they based on a legal contract between companies and a bank.[41] The arrangement is informal and there are no clearly defined rules that may serve as the basis for determining the existence of *keiretsu* and the main bank system in any particular case. In a similar way, long-term employment is not regulated by any particular law but is based on non-legal norms and practice. Finally, the government's involvement is also based the idea of trust and mutual cooperation at various levels.

Long-term employment may be used as an illustration of the relevance of non-legal norms. One of the explanations for the development of long-term employment is that it is based on economic efficiency. Puchniak in his unpublished doctoral dissertation has argued that "(D)espite a myriad of partial explanations for lifetime employment, the most powerful and straightforward explanation for its emergence and longevity has largely been overlooked:

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[38] KATHARINA PISTOR & PHILIPP A. WELLONS, THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT 1960-1995 (Oxford Univ. Press 1999).

[39] HARALD BAUM, *Emulating Japan?*, *in* JAPAN: ECONOMIC SUCCESS AND LEGAL SYSTEM 24 (Harald Baum ed. 1997).

[40] JOHN O. HALEY, THE SPIRIT OF JAPANESE LAW 14 (Univ. of Ga. Press 1998).

[41] Takeo Hoshi, *The Economic Role of Corporate Grouping and the Main Bank System*, *in* THE JAPANESE FIRM – SOURCES OF COMPETITIVE STRENGTH 287 (Masahiko Aoki & Ronald Dore eds., Oxford Univ. Press 1994).

lifetime simply makes economic sense."[42] If this is the case, why do we not find such a system in any other country in the West? After all, economic efficiency theory is normally presumed to be universally applicable. Puchniak's argument that "lifetime makes economic sense" may make sense in the case of Japan, but not at the universal level.

According to Milhaupt, "corporate norms may be the product of interest group dynamics."[43] This is one possible explanation which has some explanatory weight behind it. However, Milhaupt's explanation is incomplete as it fails to address why such norms arise in Japan, and whether the emergence of norms such as those related to long-term employment would be possible, for example, in the United States? If yes, then why is there a lack of such norms in the United States, at least in comparison to their prominence in Japan? If not, then why do such norms exist in Japan and not in the United States?

Based on previous discussion, the logical conclusion would be that an answer should be sought in the role of social norms. In contrast to the economic efficiency factors, social norms based on cultural patterns have typically a more limited scope since their application is restricted to a certain geographic area. However, an assessment of the role of non-legal norms should be made cautiously. While the role of non-legal norms in shaping the Japanese economic model is important, it should not be overestimated. Particularly, the theories that emphasize Japanese uniqueness (so-called *'Nihonjinron'* theories) should be taken with a grain of salt.[44] The factor of culture is certainly important in explaining different patterns of behavior, but it is also critical not to overstate its importance and to avoid stereotypes.

Nottage offers a recipe for how to approach these complex discussions on Japanese corporate governance: "(t)hose engaged in debates framed primarily by law and economics can benefit from greater engagement with the work of sociologists and political scientists, and vice versa."[45] I fully subscribe to this view, as the approach should not be "either or," but rather "both," in the sense that all relevant factors that determine the character and functioning of the Japanese corporate governance should be explored and given adequate assessment.

Let's try to apply this recipe to the discussion on the impact of non-legal norms on long-term employment. Assuming that long-term employment made economic sense in Japan at

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[42] Dan W. Puchniak, *Rethinking Comparative Governance: Valuable Lessons from Japan's Post-Bubble Era* 306 (2008) (unpublished LL.D. Dissertation, Kyushu Univ.) (on file with author).
[43] Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2124 (2001).
[44] PETER N. DALE, THE MYTH OF JAPANESE UNIQUENESS (Martin's Press 1986).
[45] Nottage, *supra* note 1, at 52.

the time when it was introduced, why is it still present in companies in times when allegedly it no longer makes economic sense? True, there have been some adjustments and the number of part-time employees has been substantially increased since the bubble burst, which is in line with law and economics arguments. But how do we explain the fact that long-term employment is still present in most large companies? Does it still make economic sense, or does it still fit social patterns? I think both. Long-term employment certainly has some advantages. Terminating this way of doing things could cause serious problems for companies, as most talented young Japanese still give preference to security over risky challenges. When I ask my Japanese students about the job they would like to take after the graduation, most of them say that they would like to work for the government as public servants (*komuin*) because this kind of job guarantees employment security. As long as such attitudes in society are dominant, Japanese companies will have a strong incentive to maintain long-term employment.

Milhaupt's argument that corporate norms "may be the product of interest group dynamics" is, essentially, accurate. Corporate norms are determined by the economic and political interests of the key players: business elite, politicians, the government, and labor unions in the case of long-term employment. Arguments that social norms are behind the creation of some key features of Japanese corporate governance, such as long-term employment and cross-shareholding are not sustainable. Business decisions are based on interests, attempts to balance such interests, on compromises, and not on cultural considerations or social norms. This can be put in a different way by stating that business related decisions are normally determined by "interest group dynamics," rather than by social norms. Differences between Japan and the U.S. can be explained by different "interest group dynamics" that exist in these two countries. But, what exactly is different? In the end, the differences lie in the different content, role and impact of non-legal norms, which are, in fact, closely related to the "interest group dynamics."

Social norms may influence the choice of particular corporate structures and legal rules out of a larger menu.[46] Those values are deeply embedded in people's minds and in social institutions. As a result, practices that are compatible with social preferences in other areas are more likely to work smoothly in a particular society. Reasons rooted in Japanese legal culture lie behind the way Japan has integrated foreign legal concepts, including those related to corporate governance, such as the organization of the firm and the way in which

[46] Amir N. Licht, *The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 186 (2001).

management functions. Even though the non-legal norms did not play a direct role in the process of creation of the main features of Japanese corporate governance, they had an influence in the process of their acceptance and integration in the Japanese economic model. The nature of cross-shareholding, the main bank system and long-term employment, as well as the role of the government are perfectly congruent with Japanese traditional ways of doing things. The concept of long-term employment and the way it operates are familiar to employees based on their experiences and education outside the company. So, they tend to easily adjust to their new environment due to the well-known patterns of conduct that they are accustomed to. In a similar way, cross-shareholding, the main bank system and the role of the government correspond to the traditional patterns of cooperation in Japan which enhanced their successful functioning in practice.

VII. PRESENT TENDENCIES

To make an assessment of the prospects for a convergence of the Japanese model on the U.S. model, it is important to examine the present tendencies of the system. In the present Japanese corporate governance system, some trends can be identified as a result of a number of various factors, such as social changes, economic recession and legislative actions. They are visible in all areas related to corporate governance.

A. CROSS-SHAREHOLDING

The decline of cross-shareholding in Japan seems to have stopped and its demise will probably not happen anytime soon. According to a Bloomberg columnist, "the old practice of cross-shareholdings between companies and takeover defenses made a roaring comeback" as defensive mechanisms against hostile takeovers,[47] though the level of cross-shareholding, even after the increase, was still bellow its bubble peak.

The *keiretsu* system may not change significantly, though some changes have occurred

[47] William Pesek, *Japan 2008 May Put Science Fiction to Shame*, BLOOMBERG (Mar. 9, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aZIuNeKsDOQ0. On the recent resurgence of cross-shareholding, *see* Keisuke Nitta, *On the Resurgence of Cross-Shareholding – Data from the Fiscal 2008 Survey of Corporate Ownership Structure*, NLI RESEARCH (Nov. 16, 2009), http://www.nli-research.co.jp/english/economics/2009/eco091116.pdf. According to Nitta, the recent resurgence of cross-shareholding is almost exclusively result of actions by business firms, while banks remained passive (pp. 195-96).

within the system. While banks have reduced their shareholdings in the companies, the *keiretsu* will probably retain its "safety level" that makes hostile takeovers difficult. Although banks may not be able to re-establish their participation in cross-shareholding, such obstacles do not exist in the case of firms, and they have been active in re-establishing "stable shareholdings."

The main reason for this revival of cross-shareholding is the fear of hostile takeovers that increased after the deregulation of mergers and acquisitions in Japan. The new Corporation Law of 2005 allowed foreign companies some flexibility in acquiring Japanese target companies through acquiring the company's shares. Implementation of the new law was delayed for a year due to opposition from the Japanese companies which feared that the M&A provisions of the new law might allow hostile takeovers of Japanese companies by foreign firms. Eventually, these provisions became effective on May 1, 2007 despite the opposition.[48]

With respect to ownership structure, probably the most visible changes have occurred. The shareholdings of banks and insurance companies that have been traditionally management-friendly, have substantially declined in the last two decades.[49] During the same period, the foreign shareholdings have substantially increased, though more recently some downward trends have also been reported.[50]

B. LONG-TERM EMPLOYMENT

Since the collapse of the bubble economy in the 1990's, long-term employment has come under pressure as a result of economic recession. Economic decline has required Japanese companies to be more flexible in hiring and firing employees than the traditional system allowed. Many companies have decided to lay off a substantial number of employees in the process of restructuring while, in the same period, the number of part-time employees

[48] Kaho Shimizu, *Are new rules kind to hostile mergers?*, THE JAPAN TIMES (May 7, 2007), http://aws.japantimes.co.jp/news/2007/05/01/news/are-new-rules-kind-to-hostile-mergers.

[49] Stock ownership by banks declined to 4.1% in 2011, from 13.7% in 1999. In the same period stock ownership by financial institutions declined to 29.7% from 41.0%. However, a slight reverse trend is noticeable in the last few years. *See* Tokyo Stock Exchange, *Fact Book 2012*, http://www.tse.or.jp/english/market/data/factbook/b7gje60000003o32-att/b7gje6000000y9uq.pdf (last visited Oct. 10, 2012).

[50] According to *Fact Book 2012* (*supra* note 49), foreign shareholding in 2009 was 23.5%, down from 27.8% in 2007; recent years, however, show a new tendency of rising of foreign shareholding and in 2011 it increased to 26.7%.

has substantially increased.[51] In fact, the largest difference in long-term employment in the last 10 years has been the increase in part-time employees.[52] Since Japan has always had part-time employees in large companies, this is a change in scale and not in form. Recently some large listed companies have even gradually switched back to traditional long-term employment. This new tendency might be part of a change of corporate strategies regarding human resources that takes into account failures in the merit system.

Wolf has summarized in a few words the present status of long-term employment in Japan: "lifelong employment is alive – and not well."[53] It has been repeatedly argued that long-term employment is disappearing, or even that it does not exist anymore.[54] Despite such claims, many employees still believe today that they are employed for the rest of their working life at their company unless something goes very wrong. Although employment customs are said to be changing, there is still a pervasive belief that it is only really morally acceptable to resort to layoff when the company faces bankruptcy.

The government has taken several actions to dispel doubts about its attitude towards long-term employment. The Labor Standards Act was revised in 2003 and the new revised law came into effect in 2004. One of key provisions of this revision is Article 18-2 which reads: *"A dismissal shall be considered an abuse of the right to dismiss and therefore null and void if it is not based on objectively reasonable grounds and may not be recognized as socially acceptable."* This provision is clearly based on the "abuse of right" doctrine. The tendency to reinforce the protection of employees has continued in the following years. In 2007, a number of other labor statutes were adopted to further protect employee rights. The Part-time Workers Act, 1993 was revised in 2007 in an effort to improve the working conditions of part-time workers. This Revision substantially increased protection of part-time employees, particularly the provisions that for the first time introduced in Japan the prohibition of discrimination against part-time employees.

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[51] According to the Ministry of Health, Labour and Welfare Organization (MHLW) figures, there were 34.18 million regular employees in Japan at the end of 2007 (average for October–December), while non-regular employees numbered 17.38 million, or 33.7% of the total. *See* MINISTRY OF HEALTH, LABOUR, AND WELFARE, http://www.mhlw.go.jp (last visited Oct. 12, 2012).

[52] The key characteristic of part-time employment in Japan is the fact that the employee is not a regular employee, regardless of the number of working hours. Part-time employees are often hired by a fixed term contract and they are disposable according to the fluctuation of business. The same is true of other fixed-term employees (often called *"kikan-jugyoin"* or *"keiyaku-shain"*) who may work full time but are definitely non-regular workers.

[53] Wolf, *supra* note 27, at 78.

[54] *See* Wolf, *supra* note 27.

In 2007 another important statute was enacted, the Labor Contract Act.[55] The main reason for enacting this statute was the rise of temporary labor contracts, as well as the increase in labor disputes between employees and employers. This statute fills the gap by specifically defining the principles governing labor relations which were previously based on judicial precedents only, including the prohibition of the abusive exercise of the employers' rights. Article 18-2 of the revised Labor Standards Law, 2007 was incorporated into the new Labor Contract Act, 2007.

Although the economy will probably further suffer as a consequence of the global financial crisis that started in 2008, it is unlikely that the long-term system will be abandoned, though it may be further modified. Employment practices will probably remain one important segment of the Japanese model of corporate governance that has not converged with the American model, and it is not likely to converge in the foreseeable future.

C. MAIN BANK

The changes in the main bank system after the bubble burst were probably the most visible and drastic. This was the consequence of the problem of huge bad debts that caused problems to the whole banking sector, as it proved impossible to get proper returns on investments into so-called 'zombie' companies. Many of such companies were kept alive by the appearance of profitability through continuous loans of the banks which contravened the basic economic rationale that banks should not grant loans if they were aware that those loans will never be repaid. According to Puchniak, this kind of bank policy was motivated by the "self-interested bank managers" who had an interest in keeping their jobs in banks and the "self-interested Japanese government officials" who wanted to avoid the political consequences of massive bank and industry failures.[56]

As a consequence of the crises caused by bad debts, the banks had to dispose of a substantial portion of the shares they had in other companies. With reduced shareholding, the role of main banks in the monitoring of management has been diminished substantially and it will be very difficult to restore. This has raised a question on one of the most crucial issues in Japan: how to replace the role of the main bank in the monitoring of companies?

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[55] *Labor Contract Act*, THE JAPAN INSTITUTE FOR LABOUR POLICY AND TRAINING, http://www.jil.go.jp/english/laborinfo/library/documents/llj_law17.pdf (last visited Oct. 12, 2012).

[56] Dan W. Puchniak, *Perverse Rescue in the Lost Decade: Main Banks in the Pos-Bubble Era, in* CORPORATE GOVERNANCE IN THE 21ST CENTURY JAPAN'S GRADUAL TRANSFORMATION, *supra* note 1, at 103.

D. ROLE OF THE GOVERNMENT

Things have changed after the defeat of the Liberal Democratic Party (LDP) in the elections held in 2009. The Democratic Party of Japan (DPJ) won the elections by using new rhetoric based on social justice and deploring the ideas of "market fundamentalism" promoted by the previous Government. The DPJ introduced several reforms which were based on a stronger social welfare policy.[57]

The 2009 election has caused a serious blow to the Iron Triangle structure. The change in the Government has affected the traditional relations between big business and the government. Big business relied for decades on its relations with the LDP and has never tried to develop relations with the opposition parties. Naturally, the change of the Government in 2009 has disrupted those traditional ties. The changes the DPJ is introducing are undermining the relationships that have kept the triangle in place. While bureaucrats continued to protect the interests of Japan's major corporations, the power of bureaucrats has diminished as a result of the DPJ's efforts to shift power away from them and strengthen ministerial responsibility and authority. The DPJ has also pledged to take further steps against the *amakudari* practice.[58]

The next general election in Japan will be held on 16 December 2012. Most analyzes predict the defeat of the ruling DPJ and return to the power of LDP. It remains to be seen what impact this election will have on corporate governance in Japan. The victory of LDP may thwart reforms of corporate governance due to strong links between LDP and the business elite in Japan.

E. LEGAL REFORM OF CORPORATE GOVERNANCE

A sweeping reform of Japanese corporate governance laws was introduced in 2002. There are several important changes that have been introduced in the existing corporate management structure.[59]

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[57] *See Kan Urges Opposition Parties to Join Talks on Social Security Reform*, THE MAINICHI DAILY NEWS, Jan. 24, 2011.

[58] *The civil serves itself*, ECONOMIST (Aug. 27, 2010), http://www.economist.com/blogs/asiaview/2010/08/japans_revolving-door_problem.

[59] A detailed analysis of reforms introduced by the Corporation Law, 2006 is found in Eiji Takahashi & Madoka Shimizu, *Does the 2005 Reform Improve the Japanese Economy? The Current of Japanese Corporate Governance Reform*, 17 (1-2) J. INTERDISC. ECON. *See also* Special Issue: International Corporate Governance, London 25-55 (2006). This text contains a useful chart on possible designs of corporate governance structure in joint stock corporations under the new law, at

Most of the debate on reforms have revolved around the clash between the American model, which is geared towards placing primary importance on shareholders and relying on external control, and the traditional Japanese model, which is primarily a stakeholder model based on internal control. Under the new Corporation Law which entered into force in May of 2006, taking the Company Law outside the Commercial Code,[60] Japanese corporations are given the option to select from two distinct corporate governance regimes – the Reformed Large Corporation, based on the conventional Japanese model, and the New Type Company with committees with an executive officer (CEO), based on the American model.[61]

The biggest innovation was the establishment of a totally new governance structure known as the 'Committee System,' which was viewed by some scholars as a sign of the Americanization of Japanese corporate governance.[62] It may appear as such on paper. In fact, the Reform has given a chance to companies to adopt the American model, but at the same time it also enabled companies to circumvent it. Most companies have selected a revised Japanese model, rather than adopting the American model.[63]

An additional step was undertaken in 2009 by the Tokyo Stock Exchange to include as a listing requirement obligation that every listed company must have one independent, not just outside, director or corporate auditor. A large majority opted for corporate auditor, which is understandable and represents just another circumvention of the stated goal.[64] Namely,

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31. *See* http://www.law.osaka-cu.ac.jp/prof/takahash.htm.

[60] Kaishahō [Companies Act], Act No. 86 of 2005.

[61] Article 2 of the new Companies Act provides (Definitions):

(10) "Corporation with a Board of Auditors" shall mean a kabushiki kaisha which has established a Board of Auditors or a *kabushiki kaisha* in which the establishment of a Board of Auditors is required based on the provisions of this Law.

(12) "Corporation with Committees" shall mean a *kabushiki kaisha* which has established a nomination committee, an audit committee and a compensation committee (hereinafter *The Committees*).

[62] For more information on the 2002 Revision, *see* Roland Gilson & Curtis Milhaupt, *Choice as a Regulatory Reform: The case of Japanese Corporate Governance* (Columbia Law and Economics', Working Paper No. 251, 2004).

[63] Statistics of the Tokyo Stock Exchange show a decline of the number of companies with committees and increase of the companies with statutory auditors. While in 2007 the ratio for large companies was 97% : 3% in favor of companies with auditors, *White Paper of Corporate Governance 2007*, TOKYO STOCK EXCHANGE (Mar. 2007), http://www.tse.or.jp/english/listing/cg/b7gje60000003y6y-att/white_paper.pdf; in 2011 the ratio was changed and now it is 97.4% : 2.6% http://www.tse.or.jp/english/listing/cg/b7gje60000003y6y-att/20110613.pdf. Similar trends exist in mid-size type of companies.

[64] According to the TSE report, 10.6% of listed companies submitted notifications containing only outside directors; 70.7% only outside auditors, and 18.7% both outside directors and auditors; *Updated Consolidated Results of Independent Directors/Auditors Notifications*, TOKYO STOCK EXCHANGE (July 21, 2010), http://www.tse.or.jp/english/news/09/b7gje6000000817j-att/100803_a.pdf.

auditors have no power to hire and fire managers, in contrast to the BOD.

F. IMPACT OF LEGAL REFORMS

No much change is visible in Japan after all these reforms. Not many companies have embraced the U.S. type of the company. For the moment, the corporate governance reforms have not led to radical changes in the board, the presence of outside directors has not yet been adopted as a standard, and stock-options and hostile takeovers are still a rarity in Japan.[65] Long-term employment has been preserved despite increased number of part-time employees. After first signs of weakening the cross-shareholding has rebounded to certain extent. One major change is that banks have disposed most of their shares in the companies. Another major change is a substantial increase of foreign shareholding.

One of key points in the discussions on reform of corporate governance in Japan was whether the traditional model BOD dominated by insiders should be replaced by a more shareholders oriented model with more outside members. While outside directors are seen as a potentially powerful new element of monitoring, such expectations may prove to be too optimistic. It makes little sense to have outside directors who are not really independent and have no real power to influence the decision making processes. Some companies may decide to incorporate outside directors precisely because they do not consider them as a threat to the management power. According to Lawley, the committee system with outside directors may have a placebo effect in the sense that this model is perceived to provide a stronger and more transparent corporate governance system, even though this is not supported by empirical evidence.[66]

On the other hand, there are already some visible signs of change in Japan. Meetings of shareholders have become more relevant, indicating a greater readiness to accommodate the interests of shareholders. There is a growing tendency of individual shareholders attending the annual meetings and becoming more active at those meetings, often asking questions. Asset management companies and trust banks were more active at this year's annual shareholders' meetings by voting against the management proposals.[67] On average, 15% of

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[65] Dan W. Puchniak, *The Efficiency of Friendliness: Japanese Corporate Governance Succeeds Again Without Hostile Takeovers*, 5 BERKELEY BUS. L.J. 195 (2008).

[66] Peter Lawley, *Panacea or Placebo? An Empirical Analysis of the Effect of the Japanese Committee System Corporate Governance Law Reform*, *in* CORPORATE GOVERNANCE IN THE 21ST CENTURY JAPAN'S GRADUAL TRANSFORMATION, *supra* note 1, at 154.

[67] *Kabunushisōkai, 15%ni hantaihyō* [*At the Annual Meetings of Shareholders, 15% voted against*], NIHON KEIZAI SHINBUN (Sep. 24, 2010).

the management proposals were voted against, in comparison with 10% last year.[68] Those proposals included retirement allowances to directors, nomination of management and proposals for issue of warrants aimed as protection device against hostile takeovers. As a result, the duration of the meetings have also become longer and in 2011, the average duration of annual meetings was 54 minutes, 18 minutes longer than in 2000.[69]

There are a view other signs of change, but it is still premature to make predictions on the impact of legal reforms of corporate governance. Time will tell whether the present legal reforms will end up in failure and just a "formal convergence" that does not substantially change the way of doing things, or they will bring substantial changes.

VIII. FACTORS CONTRIBUTING TO CONVERGENCE

A. INCREASING ROLE OF LAW

The role of law is becoming more prominent in parallel with the process of globalization and modernization of Japanese society. Legal reforms relating to Japanese corporate governance have been numerous and often comprehensive, affecting many aspects of corporate governance.

An important step towards a greater role for law in Japan has been taken by the establishment of the Justice System Reform Council in 2001. The Council recommended substantial reforms to the Japanese legal system, including changes in legal education and increasing the number of lawyers.

The experience with legal reforms in Japan has shown that even if the reforms do not bring immediate changes, they may still bring results at a later stage. Law often serves as a complement rather than a substitute for non-legal norms. That is a sign of a gradual process of reform of a society, which enables a smooth transition from a society governed by social norms towards a society governed by legal norms. The changes introduced by the new legal reforms are significant, but the companies may need some time to digest those changes and make the necessary adjustments.

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[68] See *Id.*

[69] 1949 SHŌJIHŌMU, Nov. 30, 2011, at 13. The information on the duration of annual shareholders meetings which is regularly published in November issue of Shōjihōmu. However, it indicates no substantial change in the last five years. This year the duration was longer four minutes than in 2010 and according to this report this was a consequence of substantially longer duration of the electric companies' annual meetings following the Fukushima accident.

B. GLOBALIZATION EFFECTS

In recent years, the informal practices of corporate governance based on non-legal norms has come under pressure as a result of globalization which brought about various changes in the Japanese business and social environment. Japan has been gradually transformed, especially in the urban portion of society and among the younger generation which is naturally more inclined to accept changes and foreign influences. Younger Japanese have ideas about their careers that are different from those of their parents. They are less committed to the long-term employment system and are more likely to change companies if others offer better conditions. Even though young Japanese are very much concerned about security of their employment, it can be said that this is not really Japanese, but rather a common attitude of young people around the world.

In the process of restructuring, employees and managers have gradually adjusted to the previously painful experiences brought about by mergers.[70] This also indicates the gradual modernization of Japanese society from being family and group-oriented towards an individual-oriented society that gradually adopts Western standards.[71] Japanese society and the attitudes of the people are likely to change as society becomes increasingly commercialized and exposed to the globalization process. Although the significant changes in values and attitudes are likely to happen slowly, they carry a potential for change which may undermine the traditional ways of doing things in Japan.

C. FOREIGN SHAREHOLDERS

Foreign investment greatly increased as a result of different factors. Following the bubble burst in 1990's the value of shares dramatically dropped making it attractive for foreign investors to enter the Japanese stock market. Of course, foreign investors were motivated by very different reasons from the Japanese stable shareholders and had different priorities.[72]

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[70] The identification with the company was one of causes for problems with mergers in Japan, and difficulties in full integration between two companies. Dai-Ichi Bank and Nihon Kangyo Bank which formed Dai-Ichi Kangyo Bank is often quoted as an illustration of those difficulties, since employees of these two banks continued to identify themselves with their original banks long after the merger and the banks continued to have two separate branches operating side-by-side under the same roof.

[71] *See* Masako Ishii-Kuntz, *Collectivism or Individualism? Changing Patterns of Japanese Attitudes*, 73, SOCIOLOGY AND SOCIAL RESEARCH 174-179 (1989).

[72] Christina Ahmadjian, *Foreign Investors and Corporate Governance in Japan*, *in* CORPORATE

Foreign investors have made impact on corporate governance including board independence, transparency and disclosure, as well as by putting pressure on the management to increase dividends and value of shares.[73] California Public Employees' Retirement System (CalPERS) demanded changes similar to those it had sought in the U.S., though in a later stage there was a change in the attitude from shareholders-activist stance towards firm-specific focus.[74]

D. DOMESTIC FACTORS

The pressure also came from inside Japan. Some Japanese corporations also demanded deeper legal reforms to develop new business attract foreign investors and become more competitive. One part of large business also showed readiness to embrace new ways of doing things. A notable example is Sony, which introduced its *Shikkoyakuin* (Executive Officer) system in 1997 which served as a model for the New Type Company.[75]

The appearance of some shareholder activists, such as Takafumi Horie (known as "Horiemon"), the founder of Livedor corporation, and Yoshiaki Murakami, an outspoken investment fund manager, is an illustration of the change of attitudes within Japan. Both of them were in the center of a number of highly publicized stories, such as the attempt at a hostile takeover of NBS (Nippon Broadcasting System), which represented a sign of departing from the traditional and accepting the new ways of doing things.[76]

Some non-profit organizations are also active in promoting corporate governance reforms. One such organization is the Kabunushi (Shareholders) Ombudsman (KO) which is comprised of lawyers, accountants, academics and shareholders. It aims to reform Japanese management practices to incorporate the views of all shareholders in Japanese companies.[77] They might be visible in mass media, but their actual power and influence are rather limited.

GOVERNANCE IN JAPAN 134 (Masahiko Aoki et al eds., Oxford Univ. Press 2007).

[73] *Id.* at 144-145.

[74] Sanford M. Jacoby, 12 *Principles and Agents: CalPERS and Corporate Governance in Japan*, J. JAPAN. L. 23, 24-25 (2007).

[75] *See Corporate Governance Reform Report 2003*, SONY CORP., http://www.sony.net/SonyInfo/csr/issues/report/2003/qfhh7c00000dlrp8-att/e_2003_03.pdf (last visited Oct. 10, 2012).

[76] Tōkyō Kōtō Saibansho [Tokyo High Ct.] Mar. 23, 2005, 1173 HANREI TAIMUZU [HANTA] 125 (Appeal from Injunction Against Issuance of Warrants).

[77] *See generally* Kabunushi (Shareholders) Ombudsman, http://kabuombu.sakura.ne.jp (last visited Oct. 12, 2012).

IX. BARRIERS TO CONVERGENCE

Analysis of the legal reforms made in Japan indicates that, despite adopting some elements of the American corporate governance system, Japan has retained the most important features of its traditional model. The firm continues to be controlled by its top management, while shareholders are still deprived of effective mechanisms of control over the corporation. Despite comprehensive legal reforms, traditional patterns endure and the fundamental elements of Japanese corporate governance have not changed.[78] Some of the legal reforms in Japan have only had a symbolic effect, while some reforms brought changes only many years after they were introduced.

A. CULTURAL BARRIERS

Cultural barriers often posed obstacles or delayed the changes, particularly when cultural factors were aligned with the interests of the business elite. This can be viewed from a different perspective as suggesting that cultural arguments were used as rhetoric to mask the actual interests of the business elite that opposed the changes. This linkage between the Japanese traditional model and Japanese culture - whether true or not - was one of factors that contributed to reluctance to its change despite economic stagnation.[79]

The issue of outside directors offers an illustration of hindrances that limit the effect of changes. Japanese companies may find it difficult to integrate outside directors, at least in the initial period. It is unlikely that Japanese companies will adopt a system in which outside directors will play the dominant role. This would be contrary to Japanese corporate culture, which is inherently biased against the idea of allowing outsiders to play a dominant role in a group given the tradition of board members having longstanding and close personal relationships with each other. The recent Olympus scandal demonstrated the potential for conflicts with outsiders who dare to challenge the way business is done in Japan. Michael Woodford, one of the very few foreigners who were promoted to a high position in Japanese companies was sacked as the CEO of Olympus only two weeks after being appointed to this position because he questioned huge fees Olympus made to obscure companies. The company explained that Mr. Woodford was sacked "because of his inability to grasp Japanese

[78] HALEY, *supra* note 40.
[79] Christina Ahmadjian & Ariyoshi Okumura, *Corporate Governance in Japan*, *in* HANDBOOK ON INTERNATIONAL CORPORATE GOVERNANCE: COUNTRY ANALYSES 252 (Christine A. Mallin ed., Edward Elgar Publishing 2011).

corporate culture."[80] A cynical view would be that disclosure of the wrongdoings has caused more damage to Olympus than wrongdoings themselves. From the short-term perspective of the shareholders' interests this may be so. However, this kind of cover up of wrongdoings cannot be in the long term interests of Olympus and is certainly damaging for the international reputation of Japanese companies. Still, the Olympus incident may adversely affect the chances for having more independent directors in Japan.

Having outsiders as key decision makers also contravenes the traditional way of decision making process based on *nemawashi*[81] and *ringi-sho,*[82] where the key role is played by a consensus rather than by individuals. The opposition to outside directors is, in fact, related to the interests of the business elite rather than being determined by cultural factors, even though such an attitude fits cultural patterns towards outsiders. Why would powerful senior managers adopt a system that would reduce their power by placing some key decisions under the authority of outside directors? The importance of this aspect of Japanese business culture may prove to be a stumbling block for a system of external control based on outside directors.[83]

It can be presumed that non-legal norms will continue to act as a hindrance to the convergence of corporate governance, despite legal reforms. No legal reform can easily change the traditional ways of doing things, such as *nemawashi.*[84] How then can the Japanese model converge with the American one when the process of making decisions remains quite divergent? These informal ways are deeply rooted in the Japanese way of doing things and cannot be changed overnight through legislation.

Informality has its advantages as it allows certain flexibility, particularly for those who can use this flexibility to achieve certain goals based on give-and-take practices. This is of essential importance in a society were consensus is cherished and dissent is suppressed. Taking away such flexibility may create serious problems for those who relied on informal

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[80] *Big Trouble in Tokyo*, ECONOMIST (Nov. 12, 2011), http://www.economist.com/node/21538154.

[81] *Nemawashi* literally means 'digging around the roots of a tree, to prepare it for a transplant.' It represents an informal process of making decision by talking to the people concerned, gathering support in order to reach a consensus, http://www.japanese123.com/ new_page_2.htm.

[82] A *ringi-sho* is a circulation document used to obtain agreement, so that by taking part in the decision making process by all relevant persons a common decision based on consensus can be reached; *ringisho*, JAPANESE1-2-3.COM, http://www.japanese123.com/ringisho.htm (last visited Oct. 10, 2012).

[83] This is illustrated by the extremely small percentage of Japanese companies that have adopted the U.S.-style board structure — which requires a minimum of two outside directors, http://www.tse.or.jp/english/ listing/cg/b7gje60000003y6y-att/20110613.pdf.

[84] *Nemawashi* is informal process of preparing ground for making a decision on a proposal by talking to the people concerned in attempt to get support for the proposal.

norms and may suddenly be exposed to abstract rules that are impersonal and universal, as this may open the way to individuals to challenge their positions. That is why the business elite opposes the legislation that would lead to a more transparent way of doing things in corporations, because this may undermine their present position.

B. BUSINESS ELITE

The business elite as the main beneficiary of the existing system is probably the strongest opponent of changes that would mean stricter monitoring and more transparency. So far it has been able to stall real reform that would go in that direction. Harsh sentences handed to those who openly challenged the traditional system might be interpreted as a warning message, [85] though the Japanese court system is independent enough to allow to be exploited for such purposes.

Managers and business elite played important role in designing legal reforms. The Keizai Doyukai, Keidanren and similar associations exercise pressure to retain some of the key features of the traditional model. They strongly opposed any reform that would curb the power and autonomy of managers and were more interested in reforms that would facilitate corporate restructuring. The result of their pressure was the optional model adopted in the text of the Company Act. The reaction to the interim report of the MOJ which provides for more drastic move towards "global standards" can serve as illustration of the attitude of the business elite toward the changes.

C. LEGAL TRANSPLANT EFFECTS

A note of caution is needed when legal norms and principles, as applied in one country, are transplanted into the legal system of another. In a new environment, legal transplants may behave in a different way from the place they were originally created. People often wrongly assume that "if rules are made to resemble each other something significant by way of rapprochement has been accomplished."[86] The assumption that the legal model is identical with the actual model used in practice is often wrong. In order to have an effective legal transplant, the law has to fit well in the new environment, so that it can be absorbed by the

[85] The Supreme Court decision of April 25, 2011 has finalized the 30 months prison sentence for Takafumi Horie; *Horie's jail sentence finalized*, THE JAPAN TIMES (May 22, 2011), http://www.japantimes.co.jp/text/nn20110522a3.html.

[86] John Merryman, *On the Convergence (and Divergence) of the Civil Law and the Common Law, in* NEW PERSPECTIVES FOR A COMMON LAW OF EUROPE 223 (M. Cappelletti ed., 1st ed. 1978).

society and implemented into practice. Otherwise, the so-called "transplant effect" may be expected, which means that the law transplanted in this way would not be widely used, at least in the initial period. Al Alan Watson stated, "(t)he act of borrowing is usually simple….building up a theory of borrowing on the other hand, seems to be an extremely complex matter."[87]

One possible explanation of the slow adoption of legal transplants in the case of Japan and some other countries in East Asia is that the Western law is based on concepts that are, to a great extent, alien to the traditional norms of those societies. The main features of Western culture that influenced its legal culture are individualism and rationalism. Individualism means that the personal autonomy and rights of individuals must be protected, often against the larger group, the State and the society. This idea is in fundamental contradiction with the idea of collectivism and submission of an individual to the community, which is typical for the Confucian philosophy. Under the concept of rationalism, conduct of the people should be governed by the rule of reason, meaning an objective standard of conduct based on reality and usefulness. In the Japanese context, rationalism has a different meaning and is related to "*giri*" - a kind of obligation that arises from a social interaction with other persons.[88] This difference derives from a contrast between the law-driven Western model and the relationship-driven Japanese model. These differences help explain why the transplantation of Western law into Japanese society resulted in a Japanese legal system that functioned much differently than its Western counterpart.

D. LACK OF CONSENSUS

The debate on corporate governance in Japan during last two decades to a great extent revolved around two contrasting views: whether Japan should adopt the U.S.-style model or should preserve its traditional model. As in many similar situations, the final outcome might be somewhere in between; when a consensus can not be reached, the compromise is used. This has been demonstrated by the contents of the amendments to the Special Act to the Commercial Code (*Shoho-tokurei-ho*) in 2002 which allowed two models of company to exist in parallel; when a consensus cannot be achieved compromise is used.

In order for real change to occur, there should be a consensus in society that those

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[87] Alan Watson, *Aspects of Reception of Law,* 44 AM. J. COMP. L. 335 (1996).

[88] For a detailed explanation of *giri, see* Yoshiuki Noda, INTRODUCTION TO JAPANESE LAW 174–83 (Univ. of Tokyo Press 1976). *See also* MERYLL DEAN, JAPANESE LEGAL SYSTEM 17-20 (Cavendish Publishing Ltd. 2002).

informal ways of doing things are outdated and on the need to start a new way of doing things. So far, no such consensus has been achieved in Japan. This is probably the biggest obstacle to change. One high ranking employee of an electronic firm was quoted in *The Economist* as saying: "Everyone knows we need to change, and no one can make the changes."[89]

X. POSSIBLE FUTURE DIRECTIONS

Despite the persistence being demonstrated by the traditional and informal ways of doing things in Japan, it would be misleading to believe that the Japanese corporate culture remains static and inflexible. Over the years, there have been gradual changes aimed at meeting the new trends and challenges brought about by the globalization process and the rapidly changing environment.

In several aspects, the changes of corporate governance are already visible or are expected to happen. Changes in the monitoring of management might provide some material for assessing the potential for convergence. Companies are increasingly exposed to the impact of the market and as a result, instead of long-term oriented governance, short-term governance aimed at improving the value of shares may become more important to companies. There are some elements which indicate that the Japanese model might move in the direction of the American model with respect to monitoring.

One of such changes is a significant shift in the objectives of the managers towards greater priority being given to the interests of shareholders. These changes were caused by a number of factors, such as a greater participation of foreign shareholders, but also by a change in the Japanese society and an ideological shift towards the rights of property.[90]

Retaining the traditional model is not really solution anymore. Times have changed. There are new circumstances that made the preservation of the old system unrealistic: the main bank lost its positions, cross-shareholding and long-term employment also lost of their previous importance, increased investment by foreign shareholders led to new priorities.

Should Japanese firms adopt the U.S. model? Not necessarily. Japan lacks some important infrastructure that is present in the U.S., such as effective stock markets and liquid labor market. The U.S. model can't function properly without a liquid labor market; its

[89] *From summit to plummet*, ECONOMIST (Feb. 18, 2012), http://www.economist.com/node/21547815.
[90] Ronald Dore, *Insider Management and Board Reform: For Whose Benefit?*, *in* CORPORATE GOVERNANCE IN JAPAN: INSTITUTIONAL CHANGE AND ORGANIZATIONAL DIVERSITY 371 (Masahiko Aoki eds., Oxford Univ. Press 2007).

absence in Japan poses serious obstacle to the adoption of the U.S. model. Also there is a continuing opposition toward independent directors, which is one of essential elements of the U.S.-style model.

One possible instrument in retaining the relational model is through labor law legislation which can limit the power of the shareholders' model. The security of employment for the regular employees and readiness of managers to link their careers for the same company are of essential importance for preserving the community firm. If these two can be ensured, giving greater protection and role to the shareholders would not endanger the preserving of traditional model. The end of long-term employment and emergence of market for managers would undermine the traditional model, but that has not yet happened.

Japan has to look for proper balance between protection of shareholders and employees. This may lead towards a competition between diverse models which will not focus only on the profit for shareholders, but mainly on creating better balance between shareholder and employee interests.[91] Shareholders' interests have to be addressed in a way that is compatible with the traditional model. A kind of *nemawashi* approach may ensure support of shareholders by giving them some concessions through a compromise and not confrontation.

The Japanese business system has become more diversified. The question is whether this is just a temporary stage in transition toward a new model, or this diversity may become of a permanent nature. If it is just a temporary stage, then what should be next stages toward the final goal? If diversity will remain permanent, what would be impact of such diversity on the business system as a whole: is it sustainable to have different forms of corporate governance within the same business system? [92]

Lack of transparency is a chronic problem of Japanese corporate governance which again came to the surface after the recent Olympus scandal.[93] The Japanese Ministry of Justice (MOJ) has commenced the process of revising the corporate law in order to strengthen the monitoring and to enhance the transparency of corporate governance. In December 2011 the Legislative Council prepared the Interim Proposal on the Revision of the Company Act.[94] Part 1 of this report contains proposals related to corporate governance. Proposed changes

[91] Takashi Araki, *Changes in Japan's Practice - Dependant Stakeholder Model and Employee Centered Corporate Governance*, *in* CORPORATE GOVERNANCE AND MANAGERIAL REFORM IN JAPAN 251 (2010).
[92] *Id.*
[93] *Supra* note 80.
[94] The text of the Interim Proposal is published at the website of the Tokyo Stock Exchange; *Interim Proposal concerning Revision of Companies Act*, COUNSELOR'S OFFICE, CIVIL AFFAIRS BUREAU, MINISTRY OF JUSTICE (Dec. 2011), http://www.tse.or.jp/english/news/09/b7gje6000000tk7a-att/b7gje6000000tkaj.pdf.

include the right of shareholders to sue board members at subsidiaries and stricter requirements for the independence of external board members. Not surprisingly, the draft includes "a separate proposal not to amend the existing corporate law in the face of objections from the business sector."[95] While the MOJ may push for deeper reforms, it is very likely that the business elite and business associations, such as *Keidanren* will try to prevent such reforms or to water them down probably relying on some sections of the government, such as the Ministry of Economy, Trade and Industry (METI).[96] Yasuhisa Abe, director of Keidanren's business infrastructure bureau, was quoted as saying on the MOJ proposal of reform: "We will smash it!"[97] *Déjà vu.*

Probably no substantial change in the direction of the American model will happen as long as the main features of the Japanese business culture remain unchanged. It is unlikely that the majority of Japanese companies will adopt the American model company, and even those companies that have adopted it may soon realize that such a model may not be effective when operating within the traditional Japanese business environment. There will probably be some adjustments to the Japanese model, but those will probably be more cosmetic rather than radical changes.

An issue that is open to discussion is to what extent the Japanese legal system has converged on the Western models.[98] There is no doubt that some steps have been made in that direction. However, this does not mean that, today, the law in Japan plays an identical role as in the West. Instead of focusing on changes in law, it may be more appropriate to consider the changes in the actual practice.

In the case of corporate governance, a number of issues have to be examined in order to make a proper assessment. For example, do the BOD and Meeting of Shareholders perform their functions in the same way as in the West? Do they strictly follow legal norms, or are they still under the influence of informal bodies and practices, such as *nemawashi*? Have *keiretsu* and the Japanese pattern of long-term employment ceased to be important features of

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[95] *Corporate law change eyed for investor suits*, THE JAPAN TIMES (Nov. 24, 2011), http://www.japantimes.co.jp/text/nn20111124a2.html.

[96] METI has established its own Study Group on corporate governance which produced its report in June 2009. Report takes a cautious approach and warns against replacement of "outside" requirement with "independence" requirement; *see The Corporate Governance Study Group Report*, MINISTRY OF ECONOMY, TRADE AND INDUSTRY (June 17, 2009), http://www.meti.go.jp/english/report/downloadfiles/200906cgst.pdf.

[97] Linda Sieg & Yoko Kubota, *Little Appetite in Japan for Major post-Olympus reform*, REUTERS (Dec. 12, 2011), http://www.reuters.com/article/2011/12/12/us-olympus-governance-idUSTRE7BB0HN20111212.

[98] The existence of Western models has been questioned, as corporate governance models in the West are also undergoing significant changes: *See* Puchniak, *supra* note 42, at 9.

Japanese corporate governance? Until clear evidence is produced that such informal bodies and practices have ceased to play an important role in Japanese corporate governance, the argument that the Japanese model operates in the same way as in the West will remain questionable.

Japanese corporate governance is changing in a significant and often unpredictable way. The existing uncertainty is more about the extent and pace of changes, rather than whether the changes are necessary and in what direction the changes will move. Based on the assessment of various factors of change analyzed above, it can be expected that in the coming years, the non-legal norms will gradually weaken at the expense of the increased importance that will be given to the formal legal norms. It can also be predicted that the changes will be gradual rather than radical. The way the changes occur in Japan represents a pragmatic adaptation to the new circumstances without undermining the basic structure; the Japanese way of change represents "continuity under change" rather than a convergence with the U.S. or any other system.[99]

XI. CONCLUSION

Legal regulation of corporate governance in the post-war period in Japan has been continuously influenced by the American model. In the same period, the way corporate governance functioned in practice has significantly deviated from the American model. Differences were not only in particular features of Japanese corporate governance, such as the main bank system, *keiretsu* and long-term employment. The model of capitalism in Japan is also different than that in the U.S., as the shareholding in Japan has a different logic and structure.

The differences between American and Japanese models derive from differences in historical and social conditions in which these two systems of corporate governance have developed and operate. In principle, it is very difficult to implement legal reforms that would transform the stakeholder model into a shareholders model. The social role of corporations is too deeply rooted to be easily changed. A better approach would be to adopt only those elements of the U.S. model that can be easily integrated and would contribute to the greater efficiency of the Japanese model. In fact, at least to a certain extent, Japan has already used this approach by giving option between the "committee" and the "auditor" systems.

[99] Ulrike Shaede, *Change and Continuity in Japanese Regulation*, 1 J. JAPAN. L. 21 (1996).

Discussions on corporate governance usually focus on the legal rules. Such focus is, however, often misplaced because legal rules are only one segment of a legal system. The law plays a crucial role in designing the Japanese corporate governance system, but the role of law cannot be fully understood without considering the social and institutional aspect of a national legal system. The legal rules should be placed in a wider context, as the same rules may not operate in the same way all around the world. Law is not just words we read on a page. A range of forces lie beneath the legal norms. Tradition, social norms, ideology, economic and political interests play important roles in the way a legal system operates. Same as the Japanese language has a logic that is different from the Western languages, so the way the law functions in Japan has a logic that is different than in the West.

The question is whether behind the facade of Westernization Japan has undergone a significant transformation and whether it has accepted the idea of law and justice as they are understood in the West. It can be argued that there is a friction between the imported Western legal system on one hand and traditional Japanese values on the other. This friction may not, however, be as strong as some people may think. In line with the "*wakon yosai*" slogan, Japan has made a successful merger of Western legal concepts while at the same time preserving its own traditional values. While the globalization process has had an impact on Japanese society and the attitudes of Japanese people, some distinctly different Japanese attitudes have continued, and will continue to exist and influence various aspects of Japanese society, including the way in which corporate governance functions in practice.

Can we say that *The Times They Are a-Changin'* in Japan? The times may have already changed, but not yet sufficiently to fully embrace the new ways of doing things.

KEYWORDS

Corporate Governance, Japan, Legal Transplants, Non-legal Norms, Convergence, Legal Reforms

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THE ROLE OF WTO LAW IN THE CONSTRUCTION OF THE CHINESE LEGAL SYSTEM

*Jiaxiang Hu**

ABSTRACTS

After the Communist Party took power in mainland China in 1949, they chose to develop the diplomatic relationships with those socialist countries and closed the door to the Western world. The half-forbidden state came to an end when the so-called Cultural Revolution (1966-1976) terminated. The construction of the current Chinese legal system was started in 1979 with the implementation of the Opening Policy. The word 'opening' is a descriptive term, referring to the release of restrictions on the exchanges between the Chinese citizens/enterprises and those of other countries. Meanwhile, the Uruguay Round Negotiations under the auspices of the GATT was launched in 1986. The application for the resumption of the GATT contracting party status and then the membership of the WTO made China turn to a massive legislation. The rules concerned with the economic activities have been given the priority for consideration since then. The impact of the multilateral trade system on China is comprehensive. With the requirements of Article XVI:4 of the WTO Agreement, the WTO law has pushed China's constitutional reforms by transforming the administration from the policy-orientation to the rule-orientation. The constructing of the Chinese legal system is, on the whole, keeping pace with the forming of the multilateral trade system, which has quickened the integration of Chinese law and WTO law. For the first time, China has received a complete set of international rules, binding it on the regulations of trade in goods, trade in services and trade-related aspects of intellectual property rights. The recommendations and rulings of DSB have led to the amendments and annulment of relevant Chinese laws and regulations. All of these have eventually brought the shift of the ruling conception of the Communist Party, i.e. from the rule of man to the rule of law.

I. INTRODUCTION

On 10 March 2011, Bangguo Wu, Chairman of the National People's Congress (NPC) of China, declared at the Fourth Plenum of the 11th National People's Congress that the Chinese legal system had been established. Horizontally, this system consists of seven branches which

include constitutional law, civil and commercial law, administrative law, economic law, social law, criminal law, and procedural law. Vertically, the Chinese legal system is based on three levels of law-making, i.e. national laws, national administrative regulations and orders, and local regulations and orders. National laws are made by the National People's Congress and its Standing Committee.[1] The State Council is the sole organ responsible for making national administrative regulations. The commissions, ministries and offices directly under the State Council are authorized for issuing orders. Local regulations are made respectively by the legislative bodies and governments of the provinces, municipalities, autonomous regions and some selected cities.[2] According to Article 79 of the Legislation Law, national laws prevail over all administrative regulations and orders. National administrative regulations prevail over the orders and local regulations if they are in conflict on a specific issue.

Within the current Chinese legal system, there are altogether 237 national laws, 690 national administrative regulations and 8,600 local regulations.[3] Compared with some countries with a long legislative tradition, this looks somewhat insignificant. While in view of such a short period of legislation in China, we can conclude that this is a marvelous achievement. When the Communist Party took power in mainland China in 1949, it abolished all the laws and regulations made by the previous government. The Communist government, however, made little progress in the construction of its legal system. The Constitution and a few others including the Land Law and Marriage Law were the only legal instruments in regulating China's political affairs and civil lives for almost a quarter of a century (1954-79). Furthermore, the national laws were often replaced by the ruling party's policies. In consideration of the unfortunate consequences of the lawless state, the Central Committee of the Communist Party of China (CPC), at the third plenary meeting of its 11th National Conference in 1978, put forward the general objective as 'there must be laws to go by, the laws must be observed and strictly enforced, and law-breakers must be prosecuted.' From

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[1] The Standing Committee consists of the chairman, vice chairmen and about two hundred other members. According to Article 7 of the Legislation Law, the National People's Congress is responsible for the law-making and amending of Constitution, Civil Law, Criminal Law, National Institutional Law and other basic laws, while its Standing Committee is responsible for the law-making and amending of all other national laws.

[2] The selected cities include the special economic zones and some big cities selected by the State Council.

[3] NATIONAL PEOPLE'S CONGRESS OF CHINA, http://www.npc.gov.cn/npc/zhibo/zzzb21/node_4246.htm (last visited Aug. 17, 2011).

then on, China had undergone five stages before the current legal system was finally constructed.

The first stage finished in 1982 with the most remarkable achievements of the promulgation of a new Constitution,[4] the Criminal Law and a few others to regulate the foreign investment. The second stage started from the convening of the 12th National Conference of CPC in 1982 till the eve of the 14th National Conference of CPC in 1992 with a massive legislation including the laws regulating the political activities of the country and the daily life of common people. The third stage started from the convening of the 14th National Conference of CPC in 1992 till the eve of the 15th National Conference of CPC in 1997 with a constitutional amendment designated for establishing the market economy as the national economic structure adjustment orientation. The fourth stage started from the convening of the 15th National Conference of CPC in 1997 till the eve of the 16th National Conference of CPC in 2002 with another constitutional amendment which set the rule of law as the ultimate goal of the Chinese legal system. The fifth stage started from the convening of the 16th National Conference of CPC till the end of 2010 when the current Chinese legal system was on the whole established.

II. THE OPENING POLICY AND THE CONSTRUCTION OF THE CHINESE LEGAL SYSTEM

The construction of the Chinese legal system was started in 1979 with the implementation of the Opening Policy.[5] The word 'opening' is a descriptive term, referring to the release of restrictions on the exchanges between Chinese citizens/enterprises and those of other countries. Historically, China had been an open country until the late Qing Dynasty (1644-1912). Zhang Qian's travel to West Asia and the Middle East (138 B.C.-119 B.C.)[6] and

[4] Since 1949, there are altogether four Constitutions in China. The first three Constitutions were made in 1954, 1975 and 1978. The current Constitution was made in 1982 and has been amended several times since then.

[5] During the third plenary meeting of the 11th National Conference in 1978, the Central Committee of CPC decided to change the national priority from the ideological purification to the economic development and open the door to the whole world.

[6] Zhang Qian (164-114 B.C.), a great explorer and diplomat of West Han Dynasty (202 B.C.-9 A.D.), spent the most important years of his life in doing business with the Persian, starting the 'Silk Road' between China and the West Asia.

Zheng He's expedition to the South-Eastern Asia and East Africa (1406-1430)[7] are both important events in the history of international trade between China and other countries. After the industrial revolution in Europe, China was overtaken in its national capacity by some Western countries and gradually lost its competitiveness in the world. Forbidden City is not only the physical term referring to the Royal Palace of the Qing Dynasty, but also a metaphorical description of China at that time.

After the Bourgeoisie Revolution in 1911, which overthrew the last dynasty (Qing) of feudalist China, the Nationalist government underwent a short period of frequent exchanges with other countries. The most remarkable events during this period are that China fully involved itself in the post-war construction of world political and economic systems with the establishment of the United Nations and the GATT. Nevertheless, this opening process was interrupted with the turnover of ruling power from the Nationalist Party to the Communist Party in mainland China. Partly due to the isolation policy carried out by the Western countries and different ideals and values between China and the western world, the Communist government chose to develop the diplomatic relationships only with those communist countries and closed the door to the Western world. The half-forbidden state came to an end when the so-called Cultural Revolution (1966-1976) terminated.

Opening to the outside means a revolutionary change of the government's modes of administration and the common people's ways of thinking. On the one hand, democracy was then a luxurious word in China's political life as the committees of CPC at various levels were the sole organs responsible for the operation of national economy. Instead of national laws and administrative regulations, the ruling party's policies and orders were the canons which everyone should observe. No one would challenge the legitimacy of them. On the other hand, since all enterprises were owned by the State, the production was a closed process. All the raw materials were allocated by the government and all the products were sold by the government. The managers had no sense of competition and the staff had no worry of losing their jobs. All profits went to the government and all losses were covered by it.

One positive consequence of this State (planned) economy was that people had a

[7] Zheng He (1371-1433), a navigator of Ming Dynasty (1368-1644), traveled seven times with hundreds of ships to the South-Eastern Asia and the East Africa, to trade with other countries.

comparatively stable life though it was far from wealthy. This accounts for why the Opening Policy encountered huge resistance when it was first brought up. Competition means to smash the 'iron rice bowl' (a lifelong secure job). Enterprises were now possible to bankrupt due to bad management and the staff might lose their jobs. These sensitive issues arising from the grassroots of the society eventually touched the foundations of the ruling party. Questioning normally focused on the legitimacy of the policies and orders since the function of the ruling party is different from that of the legislative body.[8] As there were no legal instruments to regulate the foreign investment, the investors from other countries had no idea which area was open to foreign investment and how to register an enterprise.

III. THE CONSTRUCTING OF THE CURRENT CHINESE LEGAL SYSTEM IN PARALLEL WITH THE FORMING OF THE MULTILATERAL TRADE SYSTEM

Apart from these factors mentioned above, another factor which promoted the construction of the Chinese legal system was that China began to participate in the global economy. However, China lacked the knowledge of international trade rules. After thirty years' isolation from the western world, few Chinese were familiar with these rules. Meanwhile, the Uruguay Round Negotiations under the auspices of the GATT was launched in 1986. The application for the resumption of the GATT contracting party status and then the membership of the WTO made China turn to a massive legislation.[9] The rules concerned with the economic activities have been given the priority for consideration since then.

The Sino-Foreign Joint Ventures Law and the Sino-Foreign Contractual Joint Ventures

[8] Since 1954 when the First National People's Congress (NPC) was convened and the first Constitution was made, the NPC and its Standing Committee were the legislative bodies in name only as they made few laws until the Fifth National People's Congress was convened in 1978.

[9] The Chinese government, under the control of the Nationalist Party, signed the General Agreement on Tariffs and Trade in 1947 and became one of the original contracting parties of the GATT. When the Communist Party won the control over the mainland of China in 1949, the Nationalist Party retreated to the island of Taiwan and withdrew from the GATT in 1951 under Article XXXI of GATT 1947. Although this withdrawal was never recognized by the Communist Party as it claimed that the government in Taiwan could not act on behalf of China, the Chinese government began its negotiations in 1986 with the GATT for the resumption of its GATT contracting party status. Since China failed to do so before the World Trade Organization replaced the GATT, it continued the negotiations to apply for the membership of the WTO.

Law among several others were made in 1979,[10] indicating that the basic rules to regulate the foreign investment in China had been made. Connected with this initial law-making, the Interim Regulations on the Lawyers (1980),[11] Income Tax Law (1980), Economic Contract Law (1981), Trademark Law (1982), and the Income Tax Law on Sino-Joint Ventures (1983) were made shortly after that. These laws and regulations under the 1982 Constitution ensured the implementation of the Opening Policy in accordance with the stable rules.

In parallel with the Uruguay Round Negotiations, China's law-making was concerned with all aspects of its economic structure. More laws and regulations were made to protect the foreign trade and investment. They included Patent Law (1984), Law on Economic Contracts Involving Foreign Interests (1985), Law on the Accountants (1985), Principles of Civil Law (1986), Wholly-Foreign-Funded Enterprises Law (1986),[12] Law on Technology Transfer Contracts (1987), Law on the Customs Office (1987), Law on the Quality Inspection for Imported and Exported Products (1989), Copyright Law (1990), the revised Sino-Foreign Joint Ventures Law (1990), Civil Procedure Law (1991), and Maritime Law (1992). By the end of the Uruguay Round Negotiations, China had set up the basic legal structure to guide its economic development on a rule-oriented way. With the general requirements of the most-favored-nation treatment and national treatment extending to trade in services and the trade-related aspects of intellectual property right, a fundamental issue facing China then was how to transform the long-standing planned economy (non-market economy) into the market economy.

After the constitutional revision was made in 1992 to set the market economy as the objective for economic reforms, China concentrated its law-making on those connected with the building of market economy. Specifically, they included Company Law (1993), Anti-Unfair-Competition Law (1993), Advertisement Law (1994), Arbitration Law (1994), Foreign Trade Law (1994), Law on People's Bank of China (1995), Commercial Banking

[10] Sino-Foreign Joint Ventures and Sino-Foreign Contractual Joint Ventures are the two most important types of foreign investment in China. The former refers to an enterprise in which the rights and obligations are divided according to the shares of investment of each side. The later refers to an enterprise in which the rights and obligations are divided according to the contract.

[11] The Interim Regulations on Lawyers was replaced by the Law on Lawyers in 1997.

[12] A wholly-foreign-funded enterprise refers to one in which all investment comes from one investor and all the profits and risks go to this investor.

Law (1995), Guarantee Law (1995), Negotiable Instruments Law (1995), Insurance Law (1995), Auction Law (1996), Stocks Exchange Law (1998), Contract Law (1999),[13] Wholly-Funded Enterprises Law (1999), Trust Law (2001), Anti-Monopoly Law (2007). Based on almost two decades of legislation, the Central Committee of CPC set the timetable at the 15th National Congress in 1997 that the construction of the Chinese legal system was to be completed by 2010. The law-making process was quickened since then.

IV. THE NECESSITY TO KEEP THE CURRENT CHINESE LEGAL SYSTEM IN CONFORMITY WITH WTO LAW

Since it applied for the accession to the WTO, China has made great efforts to adjust its legal system to conform to the multilateral trade system. In terms of categories, China had made the necessary laws and regulations concerning trade in goods, trade in services and the trade-related aspects of intellectual property right protection when the World Trade Organization was established. While in terms of context, some of them still needed to be modified to keep in consistence with the provisions of the WTO agreements. This accounts for the fact that the major part of legislation was laid on the amendment and annulment of those existent laws and regulations in the years before 2001 when China acceded to the WTO. Among them, those concerning the treatment on foreign investment and protection of intellectual property rights are the more affected sectors.

The Sino-Foreign Joint Ventures Law and the Sino-Foreign Contractual Joint Ventures Law were first made in 1979. While these laws had several provisions which offered more favorable treatment to the foreign investment,[14] they also contained some with the restrictive effects. Article 57 of the former Implementing Regulation of Sino-Foreign Joint Ventures

[13] The Contract Law has absorbed the previous Economic Contract Law, Law on Economic Contracts Involving Foreign Interests, and Law on Technology Transfer Contracts.

[14] For example, Article 71 of the former Regulations for the Implementation of the Law on Sino-Foreign Equity Joint Ventures (July 22, 2001), ST. COUNCIL [hereinafter Implementation of the Law on Sino-Foreign Equity Joint Ventures], provided that the necessary instruments, component parts, raw materials and package materials for the joint venture were free from duties and industrial-commercial unified tax. Article 39 of the former Implementing Regulation of Sino-Foreign Contractual Joint Ventures Law had similar provisions.

Law provided that 'the joint venture has the right to decide whether it should buy the necessary machines, raw materials…in China or abroad. Under the same conditions, it *should* buy them in China (emphasis added).'[15] The word *should* in the Chinese context is almost equal to *obliged to*, which indicated that the foreign investor had to accept the listed conditions before the project of investment was approved. This is inconsistent with the provisions of the Agreement on Trade-Related Investment Measures (TRIMs). Paragraph 1 of the annexed illustrative list states that 'TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 include those which are *mandatory* or *enforceable* under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require: (a) the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion volume or value of its local production (emphasis added).' The inconsistent provisions have been changed to 'The joint venture has the right to decide whether it should buy the necessary machines, raw materials…in China or abroad' in Article 51 of the amended Regulation which was enacted in July 2001, deleting those restrictive requirements.

The second paragraph of Article 46 of the former Implementing Regulation of Wholly-Foreign-Funded Law provided that 'the enterprise has the right to sell its products in China *according to the agreed quota* (emphasis added).' The 'agreed quota' is the preset volume for the enterprise to sell its products abroad, no matter whether it is big or not. Paragraph 2 of the annexed illustrative list states that 'TRIMs are inconsistent with the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT 1994 include those which are *mandatory* or *enforceable* under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which restrict (b) the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount

[15] The Sino-Foreign Joint Ventures Law is made by the Standing Committee of NPC while the Implementation of the Law on Sino-Foreign Equity Joint Ventures is made by the State Council, which provides more detailed provisions in implementing the law.

related to the foreign exchange inflows attributable to the enterprise (emphasis added).' The restrictive paragraph concerning quota in the Implementing Regulation was removed in the amended version which was promulgated in April 2001.

China's Copyright Law was first made in 1990. With the coming into effect of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), the amended version added the rental right in 2001 in Article 10 which lists the copyrights protected by the Law. To authorize the rental right has aroused a huge debate between the video/audio copyrighters and the entertainment providers. Before the Copyright Law was amended, all the entertainment providers in China, including the Karaoke Television (KTV) Saloons, were not required to pay for the rental use of the copyright works. Article 11 of the TRIPs provides that 'In respect of at least computer programs and cinematographic works, a Member shall provide authors and their successors in title the right to authorize or to prohibit the commercial rental to the public of originals or copies of their copyright works…' Following this vein, the Copyright Administration of China issued in 2005 the Interim Measures to Regulate the Payment by the Radio Broadcasts and Television Sets to the Authors of the Videos and Audios, which requires that all radio broadcasts and television sets should pay the authors for the use of their video and audio works. Meanwhile the Copyright Administration provided a price standard as a reference for the commercial use of video and audio works.

The Trademark Law was made in 1982 when China was still not a member of the Paris Convention. There were no provisions like Article 6bis of the Convention to protect those well-known marks in the original version of Trademark Law.[16] This began to be changed in 1996 when the State Administration for Industry and Commerce issued the Interim Order on the Recognition and Regulation of Well-Known Marks.[17] Although the context of this order,

[16] Article 6bis of the Paris Convention for the Protection of Industrial Property, March 20, 1883, 21 U.S.T. 1583, 828 U.N.T.S. 305 [hereinafter the Paris Convention] (Marks: Well–Known Marks) provides that (1) The countries of the Union undertake, *ex officio*, if their legislation so permits, or at the request of an interested party, to refuse or to cancel the registration, and to prohibit the use, of a trademark which constitutes a reproduction, an imitation, or a translation, liable to create confusion, of a mark considered by the competent authority of the country of registration or use to be well known in that country as being already the mark of a person entitled to the benefits of this Convention and used for identical or similar goods. These provisions shall also apply when the essential part of the mark constitutes a reproduction of any such well–known mark or an imitation liable to create confusion therewith.

[17] This order was made shortly after the TRIPs became effective.

especially Articles 8, 9 and 10 were identical to Article 16(3) of the TRIPs,[18] the Trademark Law remained unchanged. China amended the Trademark Law in 2001 with a new article (Article 13) to add the protection of well-known marks,[19] which is in conformity with the requirements of the TRIPs.

The integration of three separate laws into the unified Contract Law in 1999 is another example to demonstrate China's willingness to observe its obligations as a WTO Member. Since the law-making was separate for the enterprises of domestic investment and three other enterprise types of foreign investment (Sino-Foreign Joint Ventures, Sino-Foreign Contractual Joint Ventures and Wholly-Foreign-Funded Enterprises) during the 1980's, China made the Economic Contract Law, the Law on Economic Contracts Involving Foreign Interests, and the Technology Contract Law in 1981, 1985 and 1987 respectively. While these laws conferred a few more favorable treatments to foreign investment, they also contained some restrictive provisions for them. For example, Article 2 of the Law on Economic Contracts Involving Foreign Interests provided that 'This Law shall apply to economic contracts concluded between enterprises or other economic organizations of the People's Republic of China and foreign enterprises, other economic organizations or individuals,' excluding the economic activities between the Chinese individuals and foreign enterprises, other economic organizations or individuals. This has been changed by the Contract Law, in which Article 2 provides that the term 'contracts' refer to agreements by which natural persons, legal persons and/or other organizations, as equal parties, establish, modify or terminate the relationships of civil rights and obligations.[20] The 'natural persons, legal

[18] Which provides that Article 6bis of the Paris Convention (1967) shall apply, *mutatis mutandis*, to goods or services which are not similar to those in respect of which a trademark is registered, provided that use of that trademark in relation to those goods or services would indicate a connection between those goods or services and the owner of the registered trademark and provided that the interests of the owner of the registered trademark are likely to be damaged by such use.

[19] Which provides that (1) the authority will refuse the application and prohibit the use of a trademark in identical or similar goods with a copy, imitation or translation of a well-known mark which has not been registered in China and the use of which will mislead the public, (2) the authority will refuse the application and prohibit the use of a trademark in not identical or not similar goods with a copy, imitation or translation of a well-known mark which has been registered in China and the use of which will mislead the public and might damage the interests of the well-known mark holder.

[20] Paragraph 2 of the same article provides that agreements concerning such civil status matters as marriage, adoption, guardianship, etc. are governed by other laws.

persons and organizations' include those from both China and other countries.[21]

V. THE IMPACT OF THE WTO DISPUTE SETTLEMENT ON THE CONSTRUCTION OF THE CHINESE LEGAL SYSTEM

The previous sections reveal that the construction of the current Chinese legal system has been pushed by internal forces. But this is only one side of the coin, the other side is that it has been pushed by external forces as well. Although Article XVI:4 of the WTO Agreement requests that each Member should ensure the conformity of its laws, regulations and administrative procedures with its obligations, for many countries including China, the multilateral trade agreements have no direct applicability within the jurisdiction of them. There are normally two ways to review whether a Member has observed its obligations or concessions: one is the regular trade policy review implemented by the WTO, and the other is the dispute settlement process initiated by a concerned Member.

Since its accession to the WTO in 2001, China has been directly involved in 36 dispute settlement cases. In nine of the disputes, China brought its complaints to other WTO Members. In the rest of them, however, China was complained about by others.[22] Compared China's major trading partners, the number of complaints against China seems somewhat insignificant.[23] While in terms of the impact of the disputes, they have contributed much to the construction of the Chinese legal system.[24] Some Members not only complained of the measures China took on their exports, they even challenged the existent Chinese laws and regulations.

The following cases are selected for analysis either because the rulings of the Dispute

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[21] Similar changes can also be found in the Foreign Trade Law. Article 8 of the former version made in 1994 excluded the possibility for private individuals to trade with foreign enterprises or individuals. This has been changed in the amended version which became effective in 2004.

[22] *Disputes by Country/Territory*, WORLD TRADE ORGANIZATION, http://www.wto.org/english/tratop_e/dispu_e/dispu_by_country_e.htm (last visited Sep. 8, 2012).

[23] *Id.*, the figures of the European Communities and the United States are 83/70 and 97/113 respectively.

[24] Among the 36 disputes, China reached agreements with other parties in about half of them during the consultations without referring the disputes to the panels. For the rest of them, some have been given the rulings by the Dispute Settlement Body, while the others are still in the process of dispute settlement.

Settlement Body have led to the amendments or annulment of the relevant Chinese laws and regulations, or because the measures complained of have touched the fundamental economic system of China.

A. AUTOMOTIVE PARTS AND COMPONENTS CASE

This is the first case in which China was complained about by other WTO Members. In 2006, the European Communities, the United States and Canada requested consultations with China regarding the latter measures affecting the imports of automotive parts and components. Since China set the automobile industry as the priority in its economic structure adjustment program, the automobile production had increased rapidly. The output of 2010 exceeded 18 million vehicles, ranking the first in the world.[25] Some of the vehicles were manufactured with domestic parts plus a few imported components, while others were just assembled in China with almost all imported components of those European, American, Japanese or Korean brands.

In view of the fact that most automobile manufacturers in China were joint ventures and they needed to import automotive parts and components from their foreign partners, China imposed a lower tariff on the automotive parts and components than on the complete vehicles. The tariff rates were 15% for the former and 25% for the latter. Some manufacturers took the advantage of this difference to circumvent the high tariff by importing parts and components, and then assembled them into complete vehicles in China. This reminds us of the similar practices Japan used in some European countries during the 1970's.

The complained-about measures intended to hold this circumvention. Specifically, they include: (a) Policy on Development of Automotive Industry (Order No.8 issued by the National Development and Reform Commission on 21 May 2004); (b) Measures for the Administration of Importation of Automotive Parts and Components for Complete Vehicles (Decree No.125),[26] which entered into force on 1 April 2005; and, (c) Rules for Determining

[25] Liu Yuying, *The Vehicle Output of China Is Over 18 Million In 2010, Ranking the First In the World,* CHINA NEWS NETWORK (Jan. 10, 2011), http://www.chinanews.com/auto/2011/01-10/2777965.shtml (last visited Sep. 2, 2011).

[26] This decree was jointly issued by the General Administration of Customs, the National Development and Reform Commission, the Ministry of Finance and the Ministry of Commerce.

Whether Imported Automotive Parts and Components Constitute Complete Vehicles (Public Announcement No.4 issued by the General Administration of Customs), which entered into force on 1 April 2005; as well as any amendments, replacements, extensions, implementing measures or other related measures.

The European Communities argued that, under the measures identified, imported automotive parts used in the manufacture of vehicles for sale in China were subject to charges equal to the tariff for complete vehicles if they were imported in excess of certain thresholds.[27] The United States complained that these measures appeared to penalize those manufacturers for using more imported parts in the manufacture of vehicles for sale in China. In the view of the United States, although China bound its tariff for automotive parts at a rate significantly lower than its tariff bindings for complete vehicles, China would be assessing a charge on imported parts equal to the tariff on complete vehicles if the imported parts were incorporated in a vehicle in excess of thresholds.[28] Canada pointed out that China imposed different charges on vehicles depending on the domestic content of the parts used in the manufacture, thus providing domestic manufacturers with an advantage. According to Canada, these measures might also have an impact on foreign investments as they conferred a more favorable treatment to enterprises conditioned on the use in vehicle production of domestic instead of imported parts. Canada added that the charges that might be assessed on automotive parts once a vehicle was complete appeared to constitute a charge in excess of

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[27] The European Communities considered that these measures were inconsistent with: Articles II:1(a), II:1(b), III:2, III:4, III:5 of the GATT 1994, as well as with the principles contained in Article III:1. Articles 2.1 and 2.2 of the TRIMs Agreement in conjunction with paragraphs 1(a) and 2(a) of the Illustrative List annexed to the Agreement. Article 3 of the SCM Agreement. China's obligations under its Access Protocol, in particular Part I, para.7.3 of the Accession Protocol, and in para.203 of the Working Party Report on the Accession of China (WP Report) in conjunction with Part I, para.1.2 of the Accession Protocol, and para.342 of the WP Report. The European Communities also considered that China had nullified or impaired the benefits accruing to the European Communities under the Accession Protocol, in particular para.93 of the WP Report, in conjunction with Part I, para.1.2 of the Accession Protocol, and para.342 of the WP Report. China-*Measures Affecting Imports of Automobile Parts*, WT/DS339/R, WT/DS340/R, WT/DS342/R, Reports of the Panel, at 4-5.

[28] The United States considered that these measures were inconsistent with the following provisions: Article 2 of the TRIMs Agreement. Articles II (including para. 1) and III (including paras. 2, 4 and 5) of the GATT 1994. Article 3 (including paras. 1 and 2) of the SCM Agreement. The Protocol of Accession (WT/L/432) (including Parts I.1.2 and I.7.3, and paras. 93 and 203 of the WP Report). The United States also considered that China had nullified or impaired the benefits accruing to the United States, directly or indirectly, under the cited agreements. China-*Measures Affecting Imports of Automobile Parts*, WT/DS339/R, WT/DS340/R, WT/DS342/R, Reports of the Panel, at 5-6.

those set forth in China's schedule of concessions. These measures seemed to provide subsidies contingent upon export performance and upon the use of domestic over imported goods.[29]

The measures at issue derived from the orders made by the relevant Commissions, Ministries and the General Administration of Customs under the State Council. The orders are lower than laws and regulations in legal status, but they are prone to be changed. They are often used to manipulate the economic programs for internal policy reasons. As for the dispute at issue, it might be true that the complained measures were designed to hold the circumvented activities, but they also had a restrictive effect on the normal imports of automotive parts and components. The threshold to distinguish whether the imported components were for complete vehicles or not had no sound grounds as the difference between the tariffs set by China lies only between the complete vehicles and the vehicle components.

Both the panel and the Appellate Body upheld the views of the complaints that China's measures were inconsistent with Article II:1(a) and Article II:1(b), first sentence, Article III:2, first sentence, Article III:4 of the GATT 1994, and not justified under Article XX(d) of the GATT 1994 as measures that are necessary to secure compliance with laws or regulations which are not inconsistent with the GATT 1994. Recognizing that the tariff concessions are as significant as the multilateral agreements, binding the WTO Members, China informed the DSB, on 15 August 2009, that the Ministry of Industry and Information Technology, and the National Development and Reform Commission had issued a joint decree to stop the implementation of relevant provisions concerning the importation of automotive parts and components in the Automobile Industry Development Policy. On 28 August 2009, the General Administration of Customs and relevant agencies promulgated a joint decree to repeal Decree 125.

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[29] Canada considered that the measures at issue were inconsistent with: The Protocol of Accession (WT/L/432) (including Parts I.1.2 and I.7.3, and paras.93 and 203 of the WP Report). Articles II (including para. 1) and III (including paras. 2, 4 and 5) of the GATT 1994. Article 2 of the TRIMs Agreement. Article 2 of the Agreement on Rules of Origin, specifically paras.(b), (c) and (d). Article 3 of the SCM Agreement. Canada considered that, in addition, China's measures might nullify or impair benefits accruing to Canada under the cited agreements. China-*Measures Affecting Imports of Automobile Parts*, WT/DS339/R, WT/DS340/R, WT/DS342/R, Reports of the Panel, at 7.

B. PROTECTION AND ENFORCEMENT OF INTELLECTUAL PROPERTY RIGHTS CASE

The concerns of other countries over China's intellectual property right protection have been serious issues of contention with Western countries long been before this dispute. The measures listed by the United States in this case as to be inconsistent with the WTO rules include the following three aspects.

The first is concerned with the thresholds for criminal procedures and penalties. The United States complained that China would not provide applicable criminal procedures and penalties in cases of willful trademark counterfeiting or copyright piracy on a commercial scale that failed to meet certain thresholds.[30] China, however, responded that it employed the thresholds across a range of commercial crimes to reflect the significance of various illegal acts for overall public and economic order and China's prioritization of criminal enforcement, prosecution and judicial resources. China added that the criminal thresholds for trademark counterfeiting and copyright piracy are reasonable and appropriate in the context of its overall legal structure and other laws on commercial crimes.[31] The Panel agreed with China and pointed out that, while China might for policy reasons frequently use thresholds to define the point at which illegal acts were considered serious enough to be criminalized, China's legal structure was capable of criminalizing certain acts without recourse to thresholds.[32] Based on these considerations, the Panel rejected the complaint of this aspect on the grounds that the United States had not made a *prima facie* case with respect to its claim.

The second aspect is concerned with the disposal of confiscated goods which had infringed the intellectual property rights. The United States complained that China's measures were inconsistent with its obligations under the TRIPs.[33] Specifically, China's customs

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[30] China set the thresholds with the following provisions: (a) Criminal Law of People's Republic of China (2nd sess. of 5th Nat'l People's Congress July 1, 1979), arts. 213, 214, 215, 217, 218, 220; (b) Interpretation by the Supreme People's Court and the Supreme People's Procuratorate on Several Issues of Concrete Application of Law in Handling Criminal Cases of Infringing Intellectual Property (I) and (II).

[31] *See* China's first written submission, paras.122-127.

[32] *See* China–*Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, WT/DS362/R, Report of the Panel, para.7.429.

[33] The measures derived from the following regulations: (a) Regulations for Customs Protection of Intellectual Property Rights, in particular Chapter 4 thereof, (b) Implementing Measures of Customs of Intellectual Property Rights, in particular Chapter 5 thereof; and (c) General Administration of Customs Announcement No.16; as well as any amendments, related measures, or implementing

authorities lacked the authority to order the destruction or disposal of infringing goods as required by Article 59 of the TRIPs Agreement. The measures at issue, in the view of the United States, created a 'compulsory scheme' so that the customs authorities must give priority to the options that allowed the goods to enter the channels of commerce or otherwise cause harm to the right holder.[34]

China explained that its customs authorities had the authority to order both the destruction and disposal of infringing goods in accordance with Article 59 of the TRIPs. *Donation to social welfare bodies* and *sale to the right holder* constitute the disposal outside the channels of commerce in such a way as to avoid harm to the right holder (emphasis as original).[35] The Panel denied the complaint as it did not consider Article 59 of the TRIPs applicable to China's customs measures insofar as those measures applied to goods destined for exportation.[36] As for the option to dispose of the infringing goods, the Panel concluded that the United States had not established the inconsistency of these measures with Article 59 of the TRIPs as it incorporated the principles set out in the first sentence of Article 46 of the same agreement. Nevertheless, the Panel, based on the fourth sentence of Article 46,[37] did not think that China's customs measures were regarded as mandatory with respect to the auction of infringing goods.[38] The Chinese customs authorities are considering more options instead of the auction as the only one available at the moment.

The third aspect is concerned with the denial of copyright and related rights protection and enforcement to works which have not been authorized for publication or distribution

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measures.

[34] *See* China–*Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, WT/DS362/R, Report of the Panel, para.7.197.

[35] *Id.* para. 7.198.

[36] Article 59 of the TRIPs provides that 'Without prejudice to other rights of action open to the right holder and subject to the right of the defendant to seek review by a judicial authority, competent authorities shall have the authority to order the destruction or disposal of infringing goods in accordance with the principles set out in Article 46. In regard to counterfeit trademark goods, the authorities shall not allow the re-exportation of the infringing goods in an unaltered state or subject them to a different customs procedure, other than in exceptional circumstances.'

[37] Which provides that 'In regard to counterfeit trademark goods, the simple removal of the trademark unlawfully affixed shall not be sufficient, other than in exceptional cases, to permit release of the goods into the channels of commerce.'

[38] In the views of the Panel, the fact that the China's customs authorities simply eradicated the infringing features, as required by Article 27 of the Customs IPR Regulations, was not sufficient to stop the infringement.

within China. This is a complicated issue concerning the scope of copyrights protected in China. The first sentence of Article 4 of the original Copyright Law provided that 'Works the publication and/or dissemination of which are prohibited by law shall not be protected by this Law.' The United States argued that several of the Berne Convention Articles with which China must comply pursuant to TRIPs Article 9.1 were relevant.[39] Specifically, it quoted Article 5(1) of the Berne Convention (1971) and ten other provisions of that Convention. The United States claimed that Article 4(1) of the Copyright Law denied to the authors of works 'the publication or dissemination of which is prohibited by law' the broad set of rights enumerated in Article 10, which largely encompassed the rights contemplated by the Berne Convention. Nor could authors of works deny protection benefit from the remedies specified in Articles 46 and 47 of the Copyright Law. Consequently, the authors of such works would not enjoy the minimum rights that are 'specially granted' by the Berne Convention.[40]

China responded that the application of Article 4(1) of the Copyright Law was not dependent on the content review or any other regulatory regime related to publication and that the only result of a finding of prohibited content in that process was a denial of authority to publish, not a denial of copyright. Specifically, works that failed the content review were not denied copyright protection. In the view of China, Article 17 of the Berne Convention subjected all of the rights otherwise granted by that Convention to the sovereign power of governments.[41] China asked the Panel to note that, under the Chinese system of copyright, 'copyright' and 'copyright protection' were distinguishable. To the extent that Article 4(1) of the Copyright Law would come into play with respect to a work, it would operate not to remove copyright, but to deny the particularized rights of private copyright enforcement.[42]

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[39] Article 9.1 of the TRIPs requires that all WTO Members should comply with Articles 1 through 21 of the Berne Convention.

[40] *See* China–*Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, WT/DS362/R, Report of the Panel, para.7.16.

[41] *Id.* para. 7.17.

[42] The United States rebutted China's arguments as follows: First, even if Article 2(2) of the Copyright Law granted protection to foreigners' works, Article 4(1) denied protection to those for which publication or dissemination was prohibited by law. Second, as Article 4 denied the exclusive rights enumerated in Article 10 of the Copyright Law, the minimum set of exclusive rights guaranteed by Article 5(1) of the Berne Convention was denied to such works. Third, Article 4(1) created significant commercial uncertainty and, where it was clear that a work had been denied copyright protection, allowed pirate to profit at the expense of the legitimate right holder, including by exporting. Article 17 of the Berne Convention did not permit Members to deny copyright

The Panel observed that neither China nor the United States alleged that the denial of protection under Article 4(1) of the Copyright Law was permitted by any of the exceptions available with respect to certain specific rights under Articles 9(2), 10 or 10*bis* of the Berne Convention. Nor did any party allege that the denial of protection under Article 4(1) of the Copyright Law was permitted by the exception provisions in Article 13 of the TRIPs. Based on these findings, the Panel concluded that China's Copyright Law, specifically the first sentence of Article 4, was inconsistent with China's obligations under (a) Article 5(1) of the Berne Convention, as incorporated by Article 9.1. of the TRIPs, and (b) Article 41.1 of the TRIPs.

The *Protection and Enforcement of Intellectual Property Rights Case* is the only one in which China, as the respondent, did not appeal the Panel Report. Compared with thirty years ago when China joined the WIPO and the Trademark Law was first made,[43] China has achieved much progress in the legislation of this sector. While in view of the mandatory requirements of the TRIPs, China still has a lot to do, especially in the aspects concerning protection and enforcement of intellectual property rights. Although China amended Article 4 of the Copyright Law shortly after the Panel Report was delivered, the debate concerning the protection and enforcement of intellectual property rights is still far from over.

C. DISTRIBUTION OF CERTAIN PUBLICATIONS AND AUDIOVISUAL ENTERTAINMENT PRODUCTS CASE

The most controversial issue arising from this dispute is the means of supplying services (including sound recording distribution services) for audiovisual home entertainment products. The United States argued that any practical differences existing between the supply of sound recordings in physical and non-physical forms were simply differences with respect to the 'means of delivery.' According to the principle of technological neutrality, these differences were not relevant to the interpretation of the scope of a GATS commitment unless

protection to authors in their respective works.

[43] After the Trademark Law was made in 1982, the Patent Law was made in 1984, the Copyright Law was made in 1990. Meanwhile, China joined the WIPO in 1980, the Paris Convention in 1985, the Madrid Agreement Concerning the International Registration of Marks in 1989, the Berne Convention in 1992.

they were specified in a Member's Schedule. The United States further pointed out that the principle of technological neutrality was supported by the Panel of the *U.S.-Gambling case*.[44]

Trade in services began to be regulated with the multilateral trade agreements only after the World Trade Organization was set up in 1995. The GATS covers all services except those supplied in the exercise of governmental authority, and all measures affecting the supply of services. The Agreement itself makes no distinction between the different technological means by which a service may be delivered, whether in person, by mail, by telephone or across the Internet. Although the development of computer technology during the Uruguay Round Negotiations was capable of supplying services through electronic means, it was far from the widespread use in international trade at that time. Therefore, it still remains debatable whether the electronic means is covered by the GATS in the same way as all other means of delivery.

The principle of technological neutrality referred by the *Gambling Case* Panel as 'largely shared among WTO Members' originated from the *Work Program on Electronic Commerce-Progress Report to the General Council* adopted by the WTO Council for Trade in Services on 19 July 1999. Paragraph 4 of the Report provides that 'It was also the general view that the GATS is technologically neutral in the sense that it does not contain any provision that distinguish between the different technological means through which a service may be supplied.' This view was not, however, unanimous since the Report added that 'some delegations expressed a view that these issues were complex and needed further examination.'[45]

China argued that this principle had never been formally accepted by WTO Members. Even if the principle had been accepted, China claimed that it only applied to different technologies used in the supply of the same service, which was not the case with respect to the distribution of sound recordings in non-physical as compared to physical form. For China, the services which were distributed on a non-physical medium were different services ('network music services'), and not 'sound recording distribution services' as it made the

[44] *See* China–*Measures Affecting the Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, WT/DS363/R, Report of the Panel, para.7.1248.
[45] *Id.* footnote 703.

commitments in its Schedule. Furthermore, China argued that it was necessary to examine the following factors with respect to the two service activities in order to determine whether they constituted the same or different services: (1) essential operational characteristics; (2) perception of the end-users; (3) international classification; and (4) the applicable international recognized legal framework.[46]

The Panel first pointed out that China did not specify the medium on which the audio content distributed when it chose to inscribe in its Schedule - 'sound recording distribution services.' According to the Panel, a Member was free on whether it would add precision to its Schedule by qualifying the terms of the commitment. A Member might add descriptive terms that specifically exclude a service supplied in a certain way, or include that service under a different heading with different commitments. It might also add precision by referring directly to a product classification system such as that contained in a WTO document (W/120) or CPC, but China had not done so. In the view of the Panel, a reference to an external classification system was in fact recommended in the Schedule Guidelines.[47]

With regard to the principle of technological neutrality raised by the United States, the Panel provided that 'in interpreting China's commitments on "sound recording distribution services," we have no need to invoke a principle of technological neutrality. We have already found that the core meaning of China's commitment on these services includes the distribution of audio content on non-physical media. The principle of technological neutrality might have come into play, had we found that China's commitment covered distribution on physical media and that there was doubt about whether it also covered the distribution of content on non-physical media. But this was not the case here.'[48] In other words, the Panel did not deny the applicability of this principle in defining the means of services. As a matter of fact, it basically accepted the Panel conclusions of the *U.S.-Gambling* case on the concerned issue, which a commitment including all means of delivery was in line with this

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[46] *Id.* paras. 7.1249, 7.1250.

[47] The 1993 Scheduling Guidelines indicate that where it is necessary to refine further a sectoral classification, this should be done on the basis of the CPC or other internationally recognized classification. See para.16 of the Guidelines.

[48] *See* China–*Measures Affecting the Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, WT/DS363/R, Report of the Panel, para. 7.1257.

principle.

From the perspective of technological development, it might be reasonable to draw the principle of technological neutrality to implement the GATS commitments of WTO Members. The development of information technology has changed the means of delivering services. People may sell or buy publications and music in a 'non-physical form' through internet. Customers can consume the on-line services like professional consultation, medical treatment or education without bothering to meet the service supplier in person. International trade in services is conducted to a very large and increasing extent through electronic means. Indeed, the revolution in computer technology caused many services, previously regarded as essentially non-tradable, to be recognized as eminently tradable and as potentially important contributors to international trade and development.

While in regard to the law interpretation, the principle of technological neutrality remains to be debated. Article 3(3) of the DSU provides that WTO Members recognize that one of the functions for dispute settlement is to 'clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law.' The 'customary rules' are normally referred to the provisions of the Vienna Convention on the Law of Treaties. According to Article 31 of this Convention, a treaty shall be interpreted in good faith in accordance with its text, relevant instruments, any subsequent agreement, practice or relevant rules of international law. Without these materials, a special meaning shall be given to a term if it is established that the parties so intended.

The implementation of one's commitments concerning trade in goods is different from that concerning trade in services. A Member is required to fix the tariff rates as its concessions on market accession for trade in goods. As for trade in services, it usually defines the sectors open for foreign services and service suppliers with a list annexed to its commitments under the GATS. China did include in Item 2-D (Audiovisual Services) of the Schedule of Specific Commitments on Services the following three sectors open for foreign services and service suppliers: (1) Audiovisual Services, (2) Videos, including entertainment software and (CPC 83202) distribution services, and (3) Sound recording distribution services. Nevertheless, China did not specify the means of 'sound recording distribution services.'

Both the Panel and the Appellate Body accepted the U.S. allegation that China's

measures to distinguish the means of service distribution through physical and non-physical forms were inconsistent with certain provisions of its Accession Protocol, the GATS, and the GATT 1994.[49] The impact of this case on the future dispute settlement is foreseeable since China has not specified most of its commitments concerning trade in services by referring directly to a product classification system. There will be more uncertainty arising out of the implementation of the GATS commitments, and China will have more disputes involving this principle. From that point of view, the principle of technological neutrality might be a panacea for others, but represents a Pandora's Box for China.

D. ANTI-DUMPING AND COUNTERVAILING DUTY INVESTIGATION CASE

Differing from the aforementioned cases, this dispute is concerned with the measures imposed by the United States as a result of four anti-dumping and countervailing duty investigations conducted by the Department of Commerce (DOC). Besides the allegations that the final DOC determinations lead to the imposition of the duties, the order to impose the duties, and certain aspects of the conduct of the underlying investigations were inconsistent with the U.S. obligations under the covered agreements, China also challenged the imposition by the United States of 'double remedies' resulting from the application of anti-dumping duties calculated under the non-market economy (NME) methodology simultaneously with countervailing duties on the same products. China argued that when it used its NME methodology, the DOC placed the producer in the position of having unsubsidized, market-determined costs of production,[50] and calculated a dumping margin based on the difference between this market-determined cost of production and the producer's export price. In China's view, a double remedy arose in all instances of concurrent imposition of countervailing duties and of anti-dumping duties calculated pursuant to a methodology

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[49] *See* China–*Measures Affecting the Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, WT/DS363/AB/R, Report of the Appellate Body, at 166.

[50] China argued that in calculating a constructed normal value, the DOC sought to ensure that the surrogate values that it used were, in fact, market-determined values and avoided the use of any surrogate value that might itself be subsidized. *See* China first written submission, para.371 and footnote 315, *inter alia* referring to the *Omnibus Trade and Competitiveness Act of 1988*, Exhibit CHI-123.

relying on surrogate values.[51] This resulted from the overlapping rationales and effects of non-market economy methodology and of countervailing duties.

China received the support from the Appellate Body on its argument of 'double remedies,'[52] but lost on two important issues. One was the interpretation of the term 'public bodies,' the other was the definition of NME. In the four investigations at issue, the DOC determined that the state-owned enterprises (SOEs) and the state-owned commercial banks (SOCBs) were majority government owned and constituted public bodies, through which China provided financial contributions in the form of certain goods or loans on more favorable terms than the market. The DOC concluded that these subsidies were specific, which was accepted by the Panel. China alleged in its appeal that the Panel erred in interpreting the term 'public bodies' in Article 1.1(a)(1) of the SCM Agreement to mean any government-controlled entity. This mistaken interpretation, in the view of China, rendered erroneous the Panel's findings which upheld the DOC's determinations.[53]

Although China has enacted the Law of the State-Owned Enterprises (1988) and the Commercial Banking Law (1995) to regulate the State-owned enterprises and commercial banks on the market orientation, the SOEs are still in a more favorable position concerning the aspects of financing, land use, allocation of raw materials, etc. The SOCBs tend to grant loans to the SOEs on more favorably terms either because they are suggested to do so by the government, or because they take the consideration of the loan safety. Article 34 of the Commercial Banking Law states that the banks are required to 'carry out their loan business upon the needs of the national economy and the social development and *under the guidance of State industrial policies* (emphasis added).' This is one of the proofs upon which the DOC

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[51] China explained that the rationale for using an NME methodology in an anti-dumping investigation subsumed the rationale for imposing countervailing duties and that these were two different approaches for remedying the fact that a producer's costs and prices were not determined by market forces. United States–*Definitive Anti-Dumping and Countervailing Duties on Certain Products from China*, WT/DS379/R, Report of the Panel, para. 14.50.

[52] The Appellate Body concluded that the imposition of double remedies, i.e., the offsetting of the same subsidization twice by the concurrent imposition of anti-dumping duties calculated on the basis of an NME methodology and countervailing duties, is inconsistent with Article 19.3 of the SCM Agreement. United States–*Definitive Anti-Dumping and Countervailing Duties on Certain Products from China*, WT/DS379/AB/R, Report of the Appellate Body, at 227.

[53] According to China, the defining characteristic of a public body was that it exercised authority vested in it by the government for the purpose of performing functions of a governmental character. *See* China's appellant's submission, para.16.

determined that the SOCBs constituted public bodies.[54] The DOC's determination on this issue was accepted by both the Panel and the Appellate Body.[55]

The issue of dealing with a non-market economy can be traced back as early as the bilateral trade agreement in 1935 between the United States and the Soviet Union. While addressing the issue of non-market economies, both official documents and economic texts employed the term 'State Trade Countries' due to the overwhelming role that the State played in the foreign trade of a group of countries, predominantly in Eastern Europe.[56] The text of GATT 1947 was silent on this issue since the GATT was designed by market economies and for market economies.[57] With the addition of new entrants and in some of which 'the centrally planned economy' was dominated, the GATT CONTRACTING PARTIES later adopted *Ad* Article VI which provides that 'It is recognized that, in the case of imports from a country which has a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State, special difficulties may exist in determining price comparability for the purposes of paragraph 1, and in such cases importing contracting parties may find it necessary to take into account the possibility that a strict comparison with domestic prices in such a country may not always be appropriate.'[58] However, no further guidance has been provided on the application of this provision. WTO Members normally relied on their own considerations to judge whether a certain Member is a market economy or non-market economy.

Article 2.7 of the Anti-Dumping Agreement acknowledges the validity of this

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[54] Issues and Decision Memorandum for the Final Determination in the Countervailing Duty Investigation of Coated Free Sheet from the People's Republic of China, at 58-60.

[55] United States–*Definitive Anti-Dumping and Countervailing Duties on Certain Products from China*, WT/DS379/R, Report of the Panel, para. 8.143, WT/DS379/AB/R, Report of the Appellate Body, at 137.

[56] *See* Alexander Polouektov, *The "Non-Market Economy" Issue in International Trade: In the Context of WTO Accessions*, Paper for the U.N. Conference on Trade and Development, UNCTAD/DITC/TNCD/MISC.20 (Oct. 9, 2002).

[57] Paragraph 3 of Article 1 of the Havana Charter lists one of the objectives for the assumed International Trade Organization as 'to further the enjoyment by all countries, on equal terms, of access to the markets, products and productive facilities which are needed for their economic prosperity and development.'

[58] *See* GATT BISD, Vol. IV, at 64. This provision dates from the 1954-55 Review Session of the GATT and has its origins of consideration of issues relating to the Working Party on the Accession of Poland.

supplementary provision.[59] WTO Members have generally taken advantage of this provision to reject cost and price information provided by those countries considered to be non-market economies. As an alternative way, they make their decisions based on the information from third party surrogate countries with market economy systems. In each case, the market economy country chosen is presumed at a level of development comparable to that of the non-market economy subject to the antidumping investigations.[60]

Treatment of the non-market economies varies greatly, depending on how the importing nations interpret the agreement.[61] The U.S. anti-dumping statute defines the 'non-market economy' as 'any foreign country that the administering authority determination does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise.'[62]

When China acceded to the WTO in 2001, it failed to receive the recognition of a market economy from other WTO Members. Paragraph (d) of Article 15 of the Protocol on the Accession of the People's Republic of China provides that 'once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated provided that the importing Member's national law contains market economy criteria as of the date of accession. In any event, the provisions of subparagraph (a)(ii) shall expire 15 years after the date of accession…' In other words, within

[59] Article 2.7 of the AD Agreement provides that 'this Article is without prejudice to the second Supplementary Provision to paragraph 1 of Article VI in Annex I to GATT 1994.'

[60] Article 10 of the SCM Agreement provides that 'Members shall take all necessary steps to ensure that the imposition of a countervailing duty on *any product* of the territory of *any Member* imported into the territory of another Member is in accordance with the provisions of Article VI of GATT 1994 and the terms of this Agreement. Countervailing duties may only be imposed pursuant to investigations initiated and conducted in accordance with the provisions of this Agreement and the Agreement on Agriculture (Emphasis added).'The SCM Agreement does not distinguish market economies or non-market economies in its application. Therefore, whether a WTO Member should be considered a non-market economy is a domestic consideration rather than a multilateral one.

[61] OLEH MALSKYY, THE CONCEPT OF THE NON-MARKET ECONOMIES IN THE ANTIDUMPING INVESTIGATIONS OF THE UNITED STATES OF AMERICA, THE EUROPEAN UNION AND THE LAW OF THE WORLD TRADE ORGANIZATION 12 (2005).

[62] In making such a determination, the U.S. administering authority shall take into account: (i) the extent to which the currency of the foreign country is convertible into the currency of other countries, (ii) the extent to which wage rates in the foreign country are determined by free bargaining between labor and management, (iii) the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country, (iv) the extent of government ownership or control of the means of production, (v) the extent of government control over the allocation of resources and over the price and output decisions of enterprises, and (vi) such other factors as the administering authority considers appropriate. *See* Trade Act of 1930, 19 U.S.C. § 1677(18)(B).

15 years after China's accession to the WTO, the issue whether China should be considered as a market economy or non-market economy is determined by the relevant WTO Members.

The impact of the determinations on the public bodies and the application of WTO countervailing rules on a non-market economy has not been limited to this case. Article 7 of China's Constitution provides that 'The State economy is the sector of socialist economy under the ownership by the whole people. It is the leading force in the national economy. The State ensures the consolidation and growth of the State economy.' The SOEs which were defined as public bodies in this case will still play a leading role in the economic development of China, and this will remain unchanged even after 2016 when the transitional period for China as a non-market economy terminates. Therefore, it is possible and perhaps even likely that the disputes concerning the treatment of the SOEs non-market economy status will continue to occur.

VI. CONCLUSION

In view of China's history of more than two thousand years of totalitarianism, we may conclude that the construction of the current legal system is an unprecedented event in China. The role of WTO law in this process shows in many respects. With the requirement of Article XVI:4 of the WTO Agreement, the multilateral trade system has pushed China's constitutional reforms by transforming the administration from the policy-orientation to the rule-orientation. For the first time, China has received a complete set of international rules, binding it on the regulations of trade in goods, trade in services and trade-related aspects of intellectual property rights. The recommendations and rulings of DSB have led to the amendments and annulment of relevant Chinese laws and regulations. The constructing of the Chinese legal system is, on the whole, keeping pace with the forming of the multilateral trade system, which has quickened the integration of Chinese law into WTO law. All of these changes have eventually brought the shift of the ruling conception of the Communist Party, i.e. from the 'rule of man' to the 'rule of law.'[63] at least in the area of international trade.

[63] The 'rule of man' is the quintessence of Confucianism, which advocates that the quality of

KEYWORDS

WTO Law, Open-door Policy, Multilateral Trade System, Chinese Legal System, Conformity

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administration depends on the morality of the rulers. In contrast to this, the advocators of the 'rule of law' insist that the rulers should abide by the laws in administration.

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STUDENT PAPER

IMPLICATIONS OF THE U.S. IRC FOR INCREASING INDIVIDUALS' ART DONATION IN RELATION TO TAX DEDUCTION

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ABSTRACTS

It is not hard to find museums and art galleries abroad that are lined with works labeled with the words "the gift of." Behind these words lie a complex set of choices that donors need to make before displaying their donations on a prestigious wall outside the home. On the other hand, many of the works in museums and art galleries in Korea do not have the same description. Rather than having permanent exhibitions, most of the exhibition schedules are filled with works that are rented from other eminent museums around the world, such as the Louvre in France, the Guggenheim in the United States, and the Victoria and Albert Museum in the U.K., to name a few. This paper deals with the underlying reasons that Korea lacks art donations and makes suggestions derived from the implication of the IRC of the U.S., dealing closely with tax considerations.

I. INTRODUCTION

What do the Museum of Modern Arts, the Whitney Museum, and the Guggenheim have in common other than the fact that they are all located in New York? The answer is that they were all built with donations from both corporations and individuals. Art donation by corporations in the United States has a long history. This has increased in the modern era as the service industry dominates and the brand image itself has become more important for corporations. For instance, the renowned Korean artist Lee Ufan had a special exhibition at the Guggenheim last year, which would have been unimaginable had it not been for donations

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from Samsung Electronics, one of the Guggenheim's two global sponsors.

According to the Federation of Korea Industries, corporations' art and athletics donations ranked third (14.9%) after educational and academic donations (36.4%) and social welfare donations (29.9%).[1] Art donations decrease sharply when it comes to individual donors. According to the "2010 Giving Korea Giving Index," individuals' art donations amounted to 0.2% of all donations made.[2] Individuals' donations in total accounted for 12.7% of all donations made by both corporations and individuals.[3] On the other hand, according to "The Executive Summary of Giving USA 2011," donations made by individuals accounted for 73% of the total amount of donations, totaling 211.77 billion dollars in the U.S.[4]

Where do the differences lie? The social and cultural backgrounds of a society are important factors that affect donation tendency. The other factor, which also has a large impact on donations, is tax benefits. In the U.S., tax law is well-suited to individuals, and the tax benefits are generous by classifying the case of individual donors more specifically and allowing a broader scope of income tax deductions.

The reasons that the rate of individual donation is small in Korea compared to other countries may vary. One reason is that current tax law in Korea does not offer proper benefits for individual donors, which consequently removes the incentive to make donations. Unlike corporations, which may have many different purposes in making charitable donations, individuals make donations mainly for tax benefits and out of philanthropic intention. Only a few organizations are qualified to get donations and offer a high percentage of income deduction. Another is that individuals lack the information needed to make charitable contributions, mainly because most art galleries are banned from publicly seeking donations. Under the act and enforcement decree on the raising and use of contributions, only museums and art galleries established as legal entities are permitted to publicly seek contributions. The act is not applicable to private organizations that are not necessarily established as legal entities. The legislative intention behind the act is to give more protection to registered legal entities than to voluntarily established organizations. Since a registered organization must meet a high level of requirements, many art galleries are left unregistered. The near absence of intermediary foundations is also a problem. Given the complexities of finding the right

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[1] FEDERATION OF KOREAN INDUSTRIES, CORPORATE COMMUNITY RELATION WHITE BOOK 57 (2007).
[2] THE BEAUTIFUL FOUNDATION, THE 10TH INTERNATIONAL SYMPOSIUM ON DONATION CULTURE BY GIVING KOREA, GIVING INDEX 29 (2010).
[3] *Id.*
[4] GIVING USA FOUNDATION, THE EXECUTIVE SUMMARY OF GIVING USA 4 (2011).

institution to donate the work and then to display it appropriately, the existence of intermediaries that link donors and potential donees is helpful. One such organization is the Art Fund, an independent U.K. charity. While its main mission is to raise money so that museums can buy art, it also helps donors who want to give away artworks.

The paper will first discuss the definition, scope, and purpose of art donation. Second, factors that motivate individuals to donate their art possessions in relation to tax policy in the United States will be addressed. The lack of tax incentives prevents individuals in Korea from making the decision to donate to museums. Third, the policy implications of the U.S. Internal Revenue Code (hereinafter "U.S. IRC") in helping individuals to decide to donate more will be discussed.

A. DEFINITION OF ART DONATION AND ITS NEED

A donation is a gift given by a physical or legal person, typically for charitable purposes and/or to benefit a cause.[5] Donations may take various forms, including cash, services, or new or used goods, including clothing, artwork, food, and vehicles.[6]

Donating art is done in the form of gifts to museums and other public or private foundations. Anyone may make a gift of his or her own property as long as the donor is mentally competent, is of age, and has a clear, unequivocal intent present at the time of transfer.[7]

Artwork can take various forms, such as photographic images, collectible posters, religious statues, watercolors, lithographs, valuable paintings, original book art donations, and so on. Whether an idea, music, or writing can be regarded as a work of art is a different issue that falls under intellectual property rights. The object of the paper is restricted to artworks that are tangible and do not raise IP issues.

Donation is different from personal expenditure. It benefits the public and creates public value itself.[8] The public availability of these artwork donations is a great asset to museums and art galleries, especially when they lack governmental support. Through funds they have

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[5] *Donation*, THE LAW DICTIONARY, http://thelawdictionary.org/donation/ (last visited Feb. 13, 2013).

[6] *In-Kind Donors,* DORCHESTER HABITAT FOR HUMANITY, http://www.dorchesterhabitat.org/inkind.html (last visited Jan. 14, 2013).

[7] LEONARD D. DUBOFF, SHERRI BURR & MICHAEL D. MURRAY, ART LAW: CASES AND MATERIALS 520 (rev. ed. 2010).

[8] STEPHEN B. COHEN, FEDERAL INCOME TAXATION: A CONCEPTUAL APPROACH 151 (Foundation Press 1989).

raised through donations or through donated artworks, they can enrich their collections and eventually benefit the public by providing a good opportunity to display donated artworks. Thus, it shall be treated differently from personal expenditures with respect to taxation.

B. PRESENT STATUS OF ART DONATIONS IN KOREA AND THE U.S.

1. ART DONATION IN KOREA

According to the Federation of Korea Industries, corporations' art and athletics donations ranked third (14.9%) after educational and academic donations (36.4%) and social welfare donations (29.9%).[9] Art donations decrease sharply when it comes to individual donors. According to the "2010 Giving Korea Giving Index," individuals' art donations amounted to 0.2% of all donations made.[10] Individuals' donations in total accounted for 12.7 % of all donations made by both corporations and individuals.[11]

The donation tendencies indicated by the statistics show two main features of charitable donations made in Korea. First, a large portion of the donations are made by corporations, and second, most of the donations are made in the form of cash or services.

2. ART DONATION IN THE U.S.

Quite unlike Korea, donations made by individuals in the U.S. account for 73% of the total amount of donations, totaling 211.77 billion dollars.[12] In addition, 5%, or 13.28 billion dollars in donations, were made by individuals for the arts, culture, and the humanities.

3. COMPARISON BETWEEN KOREA AND THE U.S.

The biggest difference between Korea and the U.S. donation tendencies, shown in the "2010 Giving Korea Giving Index" and "Giving USA 2011," was the proportion of donations from individuals. Donations from corporations were relatively high in Korea in comparison to the United States, but a chasm was noticeable in the donations made by individuals. Between 2005 and 2007, roughly 21% of taxpayers were eligible to take deductions for their

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[9] FEDERATION OF KOREA INDUSTRIES, *supra* note 1, at 57.
[10] THE BEAUTIFUL FOUNDATION, *supra* note 2, at 29.
[11] *Id.*
[12] GIVING USA FOUNDATION, *supra* note 4, at 4.

charitable contributions in the United States.[13]

Where do the differences lie? Differences in social and cultural backgrounds account for this gap to a considerable extent. In addition, the high proportion of individual donations implies that the tax benefit through art donations serves as a good incentive for individuals. In the U.S., tax law is well-suited to individuals, and tax benefits are generous by classifying the case of individual donors more specifically and allowing a broader scope of income tax deductions.

The reasons that the rate of individual donation is small in Korea compared to other countries may vary. One reason is that current tax law in Korea does not offer proper benefits to individual donors, which consequently reduces the incentive to make donations. Unlike corporations, which may have many different purposes in making charitable donations, individuals make donations mainly for tax planning purposes and out of philanthropic intention.

Only a few organizations are qualified to receive donations and offer high income deductions, which individuals are most interested in. Another is that individuals lack the information needed to make charitable contributions. This is mainly because most art galleries in Korea are banned from publicly seeking donations. Under the Enforcement Decree and the Act on the Collection and Use of Donations, only museums and art galleries that have been established as legal entities are permitted to publicly seek contributions. The act is quite useless for private organizations that are not necessarily established as legal entities. The legislative intention behind the act is to give more protection to registered legal entities than to voluntarily established organizations. Since registered organizations must meet a high level of requirements, many art galleries are left unregistered.

The near absence of intermediary foundations is also a problem. Given the complexities of finding the right institution to donate a work and then to display it appropriately, the existence of intermediaries that link donors and recipients is helpful. One such organization is the Art Fund, an independent U.K. charity. While its main mission is to raise money so that museums can buy art, it also helps donors who want to give away artworks. The paper will focus mainly on the lack of tax incentives under the existing law of Korea and the implications of the U.S. IRC regarding this issue.

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[13] *Individual Income Tax Returns*, 1304 IRS Publication 79, Table 2.1 (rev. July 2011).

II. PURPOSE OF DONATING ART

Charles Saatchi, the preeminent British contemporary art collector, recently donated a collection of 200 artworks to the U.K.[14] Let alone the fact that Mr. Saatchi himself owns an art gallery inundated with artworks, why would a corporation or an individual make charitable art donations when they do not have as many kinds of artworks as an art collector like Mr. Saatchi? It is undeniably true that museums and art galleries benefit from cash or non-cash donations. The incentives that drive donors to make charitable gifts may differ from donor to donor. The following purposes mostly represent the perspectives of people in the United States, but it is worthwhile to consider them to develop ideas for promoting art donation in Korea.

A. PERSPECTIVE OF A CORPORATION

From the perspective of corporations, the main purpose of donation is to carry out its responsibility to the community. Donation is a beneficial win-win strategy for a corporation; elevating the corporate image may make a good impression on the public and thus lead to increased market share. As for a good example, in 1966, David Rockefeller delivered a speech to the National Industrial Conference Board and stated that art donation by corporations would offer a win-win strategy for corporations. After the speech, 100 corporations supported the initiative, and in 1967, the Business Committee for the Arts was established. In 1973, the New York Arts and Business Council (ABC) was established to enable arts organizations and corporations to closely cooperate in promoting art and museums.

The tax benefit to corporations cannot be overlooked, as companies can deduct donations from their adjusted gross income (hereinafter "AGI").

B. PERSPECTIVE OF AN INDIVIDUAL

1. LIFETIME GIFT

A lifetime gift is the transfer of artworks accumulated during a collector's lifetime to a charitable recipient. Individuals make charitable donations out of personal motivations, out of philanthropic desires, or for tax planning purposes. Though many collectors could make a

[14] Sarah Murray, *Art Smart: how to donate artworks*, F.T., Mar. 24, 2011, http://www.ft.com/cms/s/0/89745b0a-4e58-11e0-a9fa-00144feab49a.html#axzz1ujVO5BNY.

bundle selling their collections, they would confront a relatively high capital gains tax, which is up to 28% on artworks. Rather than paying such a tax, one might think of donating an artwork as charity and getting a tax deduction. From time to time, the benefit of a deduction may exceed the market value deducted from the tax. Considering the commission paid to the auction house, a donation can often result in improved financial planning.

Aside from tax considerations, non-charitable lifetime gifts or artworks may have other advantages. The transaction is conducted in private rather than through a public probate process. Presumably, the donor will enjoy the lifetime satisfaction of the recipient's acknowledgment of the donor's generosity and see a work of art labeled as "the gift of" in a museum or an art gallery. The donor will also be respected by the public for sharing an artwork. The donor can also keep an eye on the recipient with regard to whether the organization responsibly handles the work.

2. TESTAMENTARY GIFT

Upon a collector's death, artwork forming a part of the collector's estate will be subject to federal and state estate taxes, and estate taxes may be payable depending on the available credits and deductions. This often outweighs the deductions he or she can get from charitable donations. The simple solution to concerns about estate taxes is to leave the artwork to an organization that qualifies for the charitable deduction and donate as a testamentary gift. It is subject to less regulation to get the maximum tax deduction compared to a lifetime gift. For example, the related use rule does not apply to testamentary gifts.

A testamentary gift is made when the collector may wish to retain possession of his or her artwork during his or her lifetime and to donate to charity only upon his or her death. The collector's estate will be entitled to an estate tax charitable deduction for the artworks' full fair market value at the time of death. Therefore, as long as the beneficiary is a public or a private charity, there is no related use requirement. It is also helpful for those who created artworks themselves or acquired an artwork as a gift from the creator since the aforementioned artworks will be considered ordinary income, which is subject to a lesser deduction. This will be dealt in detail in section IV. "The U.S. IRC on Donation of an Artwork in the U.S."

III. STATUTES ON DONATING AN ARTWORK IN KOREA

A. CORPORATE TAX ACT

1. TAX DEDUCTION

Under Article 24 of the Corporate Tax Act, donations made to museums and art museums fall under the category of "designated donations." According to the article, a corporation will get a deduction of up to 10% of its income.[15]

2. SCOPE OF QUALIFIED ORGANIZATIONS FOR DONATION

In accordance with Article 24 of the Corporate Tax Act of Korea, the state or a local government, institutions, excluding any hospitals, falling under any of the following items for facility expenses, educational expenses, scholarships, or research expenses of organizations listed on (a) to (f)[16] are qualified as "statutory donations" under which 50% of the fair market value will be deducted from the income amount.

B. INCOME TAX ACT

1. TAX DEDUCTION

Article 34 of the Income Tax Act stipulates that donations made to museums and art museums fall under the category of "designated donations." According to the article, an

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[15] Corporate Tax Act, Act No. 5581, Dec. 28, 1998, *amended by* Act No. 10423, Dec. 30, 2010, art. 24 (Non-Inclusion of Donations in Deductible Expenses), *translated in* STATUTES OF THE REPUBLIC OF KOREA (Korea Legislation Res. Inst.).

[16] Corporate Tax Act. Article 24 (4) The donations that are given to the institutions (excluding any hospital) falling under any of the following items for facility expenses, educational expenses, scholarships or research expenses of:

(a) Private schools provided for in the Private School Act;

(b) Non-profit educational foundations (limited to non-profit incorporated corporations that are founded for the purpose of building and expanding a private school, expanding its facilities, and improving the educational environment);

(c) Polytechnic colleges provided for in the Polytechnic College Act;

(d) Lifelong educational facilities in the form of the cyber university provided for in the Lifelong Education Act;

(e) Foreign educational institutions that are founded pursuant to the Special Act on Establishment and Management of Foreign Educational Institutions in Free Economic Zones and Jeju Free International City; and

(f) Industry-academic cooperation groups provided for in the Promotion of Industrial Education and Industry-Academic Cooperation Act.

individual gets a deduction of up to 30% of his or her income.[17] The scope of donations is stated in Article 78 of the Income Tax Act enforcement decree. The provision reads as shown in section III. B. 2.[18]

2. SCOPE OF QUALIFIED ORGANIZATIONS FOR DONATION

In accordance with Article 34 of the Income Tax Act of Korea, donations paid to schools, etc., falling under each of the following items as facilities expenses, educational expenses, scholarships, or research expenses made, which list from (a) to (j),[19] are "statutory donations" under which 100% of the fair market value will be deducted from the income amount.

Article 79 (Scope of Donations)

(1) Donations under Article 34 of the Act shall include the amount falling under any of the following subparagraphs:

1. The value of donated property which a businessman has given free to a person who is not in special relations under Article 98(1), with no direct connection to his/her business; and

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[17] Income Tax Act, Act No. 4803, Dec. 22, 1994, *amended by* Act No. 10408, Dec. 27, 2010, art. 34 (Exclusion of Donations from Necessary Expenses), *translated in* STATUTES OF THE REPUBLIC OF KOREA (Korea Legislation Res. Inst.).

[18] Enforcement Decree of the Income Tax Act, Presidential Decree No. 14467, Dec. 31, 1994, *amended by* Presidential Decree No. 22580, Dec. 30, 2010, art. 79, *translated in* STATUTES OF THE REPUBLIC OF KOREA (Korea Legislation Res. Inst.).

[19] Income Tax Act of Korea Article 34 (6) Donations paid to the schools, etc. under each of the following items as the facilities expenses, educational expenses, scholarships or research expenses:
(a) Private schools under the Private School Act;
(b) Non-profit educational foundation (limited to the non-profit juridical foundation established for the purpose of a new construction, extension, expansion of facilities and other improvements of educational environment of private schools);
(c) Polytechnic colleges under the Polytechnic College Act;
(d) Lifelong educational facilities in the form of a cyber college under the Lifelong Education Act (hereinafter referred to as a "cyber college");
(e) National university-affiliated hospitals under the Act on the Establishment of National University-affiliated Hospitals;
(f) Seoul National University Hospital under the Establishment of Seoul National University Hospital Act;
(g) Seoul National University Dental Hospital under the Establishment of Seoul National University Dental Hospital Act;
(h) Foreign educational institutions under the Special Act on Establishment and Operation of Foreign Educational Institutions in the Free Economic Zones and Jeju International Free City;
(i) Industry-academic cooperation groups under the Promotion of Industrial Education and Industry-Academic Cooperation Act; and
(j) Korea Advanced Institute of Science and Technology under the Korea Advanced Institute of Science and Technology Act, Gwangju Institute of Science and Technology under the Gwangju Institute of Science and Technology Act and Daegu-kyeongbuk Institute of Science and Technology under the Daegu-kyeongbuk Institute of Science and Technology Act;

2. The amount deemed to have been substantially donated out of such differences as are caused by either transferring the property at a price lower than normal price to a person who is not in special relations under Article 98(1), or purchasing it at a price higher than normal from him, without justifiable grounds. In such cases, the normal price shall be the value within the scope of 30/100 above or below of the market price.

Article 80, which deals with the scope of designated donations, follows Article 79, and museums and art museums are not explicitly listed.

IV. THE U.S. IRC ON DONATION OF AN ARTWORK IN THE U.S.

A. INTRODUCTION

In the United States, an individual is taxed twice – under federal taxation and state taxation. Deductions are first done on the federal level. In accordance with IRC Sec. 170(B)(2)(A) corporations' contribution shall be deductible up to 10% of taxable income. Since the paper focuses on donations made by individuals, codes and regulations covering individuals will be mainly dealt with hereafter.

As mentioned previously, both the lifetime gift and testamentary gift can be useful tax planning devices for a collector. Lifetime gifts can result in current deductions equal to the fair market value of the donated works that the collector may use to offset other taxable income. Testamentary transfers can provide estate tax deductions and may avoid the necessity to liquidate a portion of the estate to pay taxes on the works.[20]

Donors can take a full deduction of the property unless it amounts to 20% of their AGI. If it does, the IRC imposes significant limitations on deductions that may be taken for lifetime charitable transfers. It is important that the collector determines before making a charitable transfer the type of organization to which the contribution is to be made, the type of property that is the subject of the gift, and whether the organization will be using the property for a use related to its charitable purposes. If the fair market value of a donated artwork is over US20,000, a donor shall attach a copy of the signed appraisal issued by the Art Advisory Panel, which comprises 22 art experts, and a photograph of a size and quality

[20] STEPHEN B. COHEN, *supra* note 8.

fully showing the object.[21]

B. WHAT TO DONATE

At the outset of art donation, one must identify whether an artwork is classified as "capital gain" property or as "ordinary income" property. The distinction between characterizing a collector's artwork as either capital gain property or ordinary income property is important in transferring such property to non-charitable and charitable beneficiaries. If an owner acquires an artwork for pleasure, the artwork will ordinarily be considered capital gain property.[22] As a result, upon the collector's sale of such artwork, if held for more than one year, any appreciation in value will be taxed to the collector as long-term capital gain. Artwork that is held in inventory by a dealer, created by the taxpayer, received as a gift from the creator, or owned for one year will be considered ordinary income property.[23]

C. WHERE TO DONATE

It is also important to verify the charitable status of the prospective recipient and to determine whether the entity is a public or a private charity. The percentage of the deduction will differ from donee organization to donee organization. Public charities include museums, schools, hospitals, churches, other publicly supported organizations and certain foundations that meet certain conditions, and private operating foundations.

1. SCOPE OF QUALIFIED ORGANIZATION FOR DONATION

Charitable contributions made to organizations listed in IRS Publication 78, otherwise qualified under section 170(c) of the IRC, are deductible. The 50% limitation applies to all public charities, all private operating foundations, and certain types of private foundations. The 30% limitation applies to private foundations other than those previously mentioned that qualify for 50% and to other organization described in section 170(c) that do not qualify for the 50% limitation.

The IRC gives leeway in the scope of organizations where the 50% deduction is made.

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[21] 561 IRS Publication 4 (rev. Apr. 2007).
[22] Austin T. Wilkie, *Advising the Collector*, 44 TRUSTS AND ESTATES LAW SECTIONAL NEWSL. (N.Y. ST. B.A., New York, N.Y.), No. 2, at 5 (2011).
[23] *Id.*

A private foundation can qualify as a supporting organization of a public charity if certain conditions are met.[24] There are very detailed regulations on how closely a privately formed entity must work with a public entity to qualify as a supporting organization.[25] To be qualified as the most loosely connected supporting organization, the entity must satisfy a "responsiveness" test and an "integral" part test. The "responsiveness" test is satisfied when the officers, directors, or trustees of the supporting organization maintain a close and continuous relationship with the officers, directors, or trustees of the publicly supported organization.[26] Either carrying out one of the functions of the public charity or providing it with such financial support as will lead the public charity to be attentive to the supporting entity satisfies the "integral part" test.[27] Within the forgoing framework, it should not be too difficult to design an organization that establishes a connection with a museum or an educational organization and avoids private-foundation status.

D. LIMITATION OF DEDUCTIONS

In general, contributions to charitable organizations may be deducted up to 50% of adjusted gross income computed without regard to net operating loss carry-backs. Contributions to certain private foundations, veterans' organizations, fraternal societies, and cemetery organizations are limited to 30% of adjusted gross income (computed without regard to net operating loss carry-backs). Publication 78 uses a coding system to indicate these limitations.

The 50% limitation applies to: (1) all public charities (no code), (2) all private operating foundations (code 3), (3) certain private foundations that distribute the contributions they receive to public charities and private operating foundations within two and a half months following the year of receipt, and (4) certain private foundations, the contributions to which are pooled in a common fund and the income and corpus of which are paid to public charities.

The 30% limitation applies to private foundations[28] and to other organizations described in section 170(c) that do not qualify for the 50% limitation.[29] The other organizations that qualify for the 30% limitation are organizations such as fraternal societies and veterans'

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[24] I.R.C. § 509 (a)(3).
[25] Treas. Reg. § 1.509 (a)- 4(i)(1)(i).
[26] Treas. Reg. § 1.509 (a)- 4(i)(2)(ii)(c).
[27] Treas. Reg. § 1.509 (a)- 4(i)(3)(ii), (iii).
[28] 78 I.R.S. Publication, code 4 – other than those previously mentioned that qualify for 50% (June 20, 2011).
[29] *Id.* codes 2, 6, 7.

organizations.

V. IMPLICATIONS OF THE U.S. IRC

Discussion on the need for codification of the Mecenat Special Law is ongoing in Korea. The law deals with the full deduction on a contribution basis and eliminating the limit on the deduction in case the fees are provided in relation to cultural use. However, all these discussions are limited to corporations. Debate on introducing the Mecenat Special Law confronted opposition because a decrease in tax revenues was expected. Quite contrary to the opposing parties' concerns, according to a survey conducted in March 2010 by 500 major corporations, it was found that, "although there will be a decrease of 7 billion Korean Won in collecting tax, it will generate a cultural-political effect that would amount to 29 billion Korean won if the Act is adopted."[30] Additionally, considering the administrative fees that are involved in collecting taxes, selecting organizations to support, and so on, it is more cost-efficient to promote corporate donations and provide tax benefits accordingly.[31]

In other countries, Mecenat activity has greatly increased since the codification of related statutes. For instance, France introduced the act in August 2003, deducting 60% of the expense within 0.5% of the total sales of the corporation. After the introduction, donations increased more than three times compared to before it was introduced.[32]

While active discussions are made regarding the tax benefits that corporations can enjoy, few of the discussions concerned individuals. The U.S. IRC, which set a higher deduction rate for donations made by individuals than by corporations, provides some implications for tax incentives that benefit individual donors. Among the implications, fractional giving (V. D. 1.), which enables donors to enjoy possession and lengthier tax benefits, is worth noting.

A. CONTRIBUTION BASE SYSTEM

Donors in the United States can take a full deduction on the property unless it amounts to 20% of their AGI. If it does, deductions are subjected to a certain percentage of the contribution.

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[30] Seulgi Kim, *Sesu 300eok juleodeundago yesuljiwon gil mangna [Prohibiting funding for art just because of 30B Won drop in tax revenue?]*, MK NEWS, Aug. 30, 2011, http://news.mk.co.kr/newsRead.php?year=2011&no=563829.

[31] *Id.*

[32] *Id.*

The current tax act in Korea is not the best mechanism for motivating individuals to donate artworks of high value. Regardless of the market value of the property, an individual donor in Korea gets up to a 10% deduction on his or her income unless it falls under "statutory donations," which is rare. In contrast, the U.S. IRC offers a tax deduction on a contribution basis that motivates the donation of valuable properties. Donors have faith that they will get a fair amount of deductions in the end.

B. Broad Scope of Qualified Organizations for Donation

The scope of qualified organizations for donation, where an individual or a corporation can get a high-percentage tax benefit from donation, differs greatly between Korea and the U.S. In Korea, charitable gifts to museums and art galleries are classified as "designated donations" that are deducted up to 30% for an individual and 10% for a corporation. 100% is deducted for an individual and 50% for a corporation if an art charity has been made to the state or a local government, where a donation will be classified as a "statutory donation."

On the other hand, the IRC provides a broader scope for qualified organizations for donation where an individual or a corporation can get a 50% deduction (if the total amount of contributions for the year is 20% or less of adjusted gross income, it will be deducted in full). The 50% limitation applies to all public charities, private operating foundations, and certain types of private foundations. It also opens an opportunity for a private organization to gain tax beneficiary status similar to that of a public charity if certain conditions are satisfied. Also, in Korea, it is not possible to change the classification of an entity. Even in same group of classification, it is hard to change a "designated donation" into a "statutory donation" that would offer a bigger deduction.

The broader the scope of organizations where an individual or a corporation can get a tax benefit, the more charitable donations will be made. The U.S. IRC provides good implications for one way of increasing charitable donations.

C. Regulations Regarding the Prevention of Tax Avoidance

While the U.S. IRC seems to open a wide range of tax deductions, the code also sets regulations to prevent tax avoidance. One of the biggest problems that concerned policymakers in Korea was the mis-valuation of donated artwork because it would lead to miscalculation of the amount of the tax deduction and sometimes motivate people to

conveniently evade taxes. The U.S. IRC provides a mechanism for effectively preventing tax evasion.

1. THE SPECIAL 30% LIMITATION RULE[33]

The special 30% limitation rule applies to gifts of capital gain property to 50% limit organizations.[34] If artworks constitute capital gain property in the hands of the collector, a further limitation is imposed upon the amount that is deductible by the collector. Deductions for contributions of such property will be subject to a maximum deduction limitation of 30% of the taxpayer's contribution base.

The legislative intent behind the special 30% rule is that, once the property has been turned into any other type of capital gain, one should pay an acquisition tax regardless of the form it takes. If it is still deductible up to 50% of the contribution basis, it amounts to twice the deduction, a deduction from donating capital property, and a deduction from the transfer tax. Once the amount of deduction is up to 50%, even in the case of capital gain property, one is more likely to facilitate tax evasion through donation. To prevent this, the special 30% rule has been legislated.

The special 30% limitation is not applicable to contributions of capital gain property to a 20% non-public charity, but the deduction for such contribution is reduced by 50% of any appreciation in the value of the property. After such a reduction, the deduction is limited to the lesser amount of 20% of the donor's contribution base or the excess of 50% of the donor's contribution base over the amount of charitable contributions allowable to public charities and other 50% organizations determined without regard to the 30% limitation. Unlike the case of public charities, the percentage limitation for 20% non-public charities may not be carried forward to subsequent tax years.

2. RELATED USE TEST

If donated goods are not used in relation to the function or purpose of the donee public charity, the deduction will be reduced by 50% of the appreciated value of the property donated. This means that, if the contribution is for an unrelated use, the deduction will first be reduced by 50% of the long-term capital gain element of value, and the resulting figure will

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[33] I.R.C. § 170(b)(1)(C).
[34] *Special 30% Limit for Capital Gain Property*, 526 I.R.S. Publication 14 (2010).

be deductible only up to 50% of the taxpayer's contribution base.[35] Thus, if a work is donated to a museum for resale, such use may not constitute a related use. A contribution for a related use may be established by a collector in two ways – either by showing that the property was put to a related use by the recipient organization or by showing that, at the time of contribution, it was reasonable to anticipate that the property would be put to a related use.

D. DIVERSIFIED METHODS OF DONATION

While an outright gift is the most common way of making a donation, the IRC stipulates diverse methods of donating an artwork, whereas no such stipulation can be found in Korea. Considering the fact that the fractional gift has been the major route for donations, ensuring various methods of donation would satisfy the different motivations of donors.

1. FRACTIONAL INTEREST IN TANGIBLE PERSONAL PROPERTY[36]

Fractional giving is one of the donation methods that allow a donor to make a series of partial donations over an extended period.[37] Suppose that a donor plans to donate one of his collections and maximize his tax benefits through the donation. If it is donated to a public charity, the deduction allowed in the year of transfer is limited to 30% of the taxpayer's contribution basis, and any amount that exceeds the 30% limitation may be carried forward for five years.[38] It will be largely the same except that it is subjected to a 20% limitation.[39] To benefit over an extended period, the donor might decide to donate fractionally, donating 10% of a piece of art to a museum each year over ten years.

Since the Pension Protection Act of 2006, there has been a decrease in the tax benefit that a donor can get from donating fractional interest. There is an ongoing debate regarding whether the Pension Protection Act is appropriate. Critiques and policy recommendations have been given by museums and legal scholars. Nonetheless, fractional giving constitutes a large portion of donations of great pieces of art, and in this paper, the act before the revision will be dealt with.

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[35] SCOTT HODES, LEGAL RIGHTS IN THE ART AND COLLECTOR'S WORLD 86 (Oceana Publications 1986).
[36] I.R.C. § 170(o).
[37] Rachel E. Silverman, *Wealth Manager: Joint Custody for Your Monet: 'Fractional Giving' Hits the Art World, as Donors Share Works with Museums*, WALL ST. J., July 6, 2005, at D1.
[38] I.R.C. § 70(b)(1)(C)(ii).
[39] I.R.C. § 70(b)(1)(C)(7).

Fractional giving, the donation of portions of an artwork to a museum over an extended period, has resulted in major contributions to museums in the United States. Although fractional gifts account for only 3% of all charitable donations to museums,[40] the quality of works that museum donors have contributed through fractional gifts highlights the importance of the practice.

Fractional giving has been encouraged by beneficial tax deduction rules that allowed a donor to claim a charitable contribution deduction against taxable income equal to the value of the partial donation in each year in which a fraction is donated.[41] In general, no charitable income tax deduction is available for a gift of less than a donor's entire interest in the property. However, a donor could give an "undivided portion" of her entire interest in the property and still receive a deduction. Thus, a donor could claim a charitable deduction each year equal to the portion of the gift donated to charity that year and maintain the right of possession for the remainder.

Fractional giving of art is generally deductible at the fair market value.[42] If a fractional gift and subsequent fractional gifts are made, then the future deductions will be based on the lesser of the initial asset value or the value at the time of the future fractional gift.[43] If the value of the work has increased during the period of giving, the donation is evaluated on an existing value basis, which enables the donor to benefit more compared to valuation done at the time of donation. If the donor passes away prior to completing the gift, the balance of the fractional art gift will be testamentary.

2. QUALIFIED CONSERVATION CONTRIBUTION

It is not always easy to conserve an antique or an artwork at home in perfect condition, and one might fear that being unable to conserve it in an appropriate way could result in deterioration of the value of a piece. In this case, one can think of donating a piece of artwork as a qualified conservation contribution. It is the contribution of a qualified real property interest to a qualified organization to be used only for conservation purposes.[44] For example, contributions of conservation easements, historic preservation easements, and facade

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[40] Sarah Murray, *Museums Fear Tax Law Changes on Some Donations*, N.Y. TIMES, Sept. 13, 2006.
[41] Graham Green, *Fractional Giving after the Pension Protection Act of 2006*, 2 ART LAW CLIENT NEWSL. (Harv. L. Sch. The Hale and Dorr Legal Services Ctr., Cambridge, MA), No. 1, Spring 2007, at 1.
[42] Treas. Reg. § 1.170A-5(a)(2).
[43] I.R.C. § 170(o)(2)(A).
[44] Pension Protection Act of 2006, Pub. L. No. 109-280, § 170(h).

easements are qualified conservation contributions. Qualified organizations include governmental units; publicly supported charitable, religious, scientific, literary, educational, organizations, etc.; or organizations controlled by and operated for the exclusive benefit of a governmental unit or publicly supported charity. The organization must also make a commitment to protect the conservation purposes of the donation and must have the resources to enforce the restrictions.[45] An individual can deduct the appraised value of the donated property interest up to 50% of AGI.

3. FUTURE INTEREST IN TANGIBLE PERSONAL PROPERTY

Deductions occur only after all intervening interests in and rights to the actual possession or enjoyment of the property have either expired or been turned over to someone other than the donor, a related person, or a related organization. Related persons include a spouse, children, grandchildren, brothers, sisters, and parents. Related organizations may include partnerships or corporations that a donor has an interest in or an estate or trust that a donor has a connection with. Future interest means any interest that is to begin at some time in the future, regardless of whether it is designated as a future interest under state law.

4. CHARITABLE BARGAIN SALE

The IRS defines a bargain sale as "a transfer of property that is in part a sale or exchange and in part a contribution."[46] A bargain sale of personal property to a qualified charitable organization is selling or exchanging an artwork for less than the fair market value of the property. It is partly a charitable contribution and partly a sale or exchange. If a donor wants to donate an artwork to his or her favorite museum and generate income from the donation at the same time, a bargain sale would permit one to do so. One donates a portion of the artwork to the museum, and the museum purchases the remaining part for far less than the fair market value of the work. The amount of the deduction that a donor may take in this case is the difference between the fair market value and the sales price of the object.

A charitable contribution through a bargain sale sounds like a win-win strategy, especially when the value of a donated artwork has greatly risen. The donor makes money, the museum gets an artwork, and the public gets access to a masterpiece that would otherwise

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[45] *Qualified Conservation Contribution*, 526 IRS Publication 9 (2011).
[46] I.R.S. Instructions for Form 8283 Section B. Part I. Line 5, Column (g)

be seen only in the privacy of the donor's home. The problem with donation through bargain sales is that it bears the risk of exaggerating the fair market value of an artwork to enlarge the amount of the deduction. A donor might declare the artwork to be worth much more than its actual value and claim an inflated charitable deduction. To prevent excessive value inflation, IRS Publication 526 imposes a "penalty." One may be liable for a penalty if one overstates the value or adjusted basis of the donated property.

VI. CONCLUSION

The legislative intent and purpose of the article addressing tax deductions in the Income Tax Law of Korea are to promote donations by providing tax benefits. In assessing whether the law is achieving its goal, the statistics cast huge doubt. Social, cultural, and historical differences may account for the gap shown in the statistics. Another explanation is that the law is not effectively molded to motivate donations from individuals. In the United States, where over 90% of artworks in museums are donated by individuals, there are policy implications for Korea to refer to. Under the U.S. IRC, donating art may provide an immediate income tax deduction. Deductions are made on a broad contribution basis. Donations are classified specifically based on donors, recipients, and the value of the artworks to determine the amounts used to compute a fair deduction amount for each donor. Accuracy and fairness in deduction amounts is one of the strong points that encourage U.S. citizens to donate more than Koreans. A donor does not want to fall behind another donor by receiving a deduction of the same size when a former donor contributed more than the latter and vice versa.

The U.S. IRC encourages individuals to donate more artworks than does the Tax Act of Korea by giving good implications and incentives. Arranging diverse methods of donation will also serve as a good motivator for a potential donor. From a recipient's perspective, obtaining a donation is important regardless of the form it takes.

KEYWORDS

Art Donation, Tax Deduction, the IRC, Charitable Gifts, Qualified Organizations for Donation

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