

**Towards the Convergence of National Corporate Governance systems?
Unlike to happened.♦**

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Summary: Introduction, German-Japanese Model, The current Chinese Corporate Governance and its development, Japanese Corporate Governance System.

Introduction

It is undoubtedly true that the entire world is experiencing a fundamental shift in its economy. This perceivable phenomenon has been the result of a dramatic international trade and cultural exchange, defined as Globalization. It refers basically to the increase of trading and foreign direct investing² due to the decline of barriers and interdependence of countries (Hill, 2005). Other factors that have considerably contributed to this economic situation may be listed as increased technological capabilities, development of supporting services (Mohr, 2005), advance in transportation and communication technology of developed countries (Begg, 2005), and all linked to the new ideology of neoliberalism and the free market. In this sense, corporate governance is not an isolated issue from this trend. There is clear evidence that some countries have adopted institutions belonging to both the Anglo-Saxon system and German-Japanese models to be included in their own corporate governance as a consequence of globalization (Hofstede, 2004)³. Even more, countries previously under communist regimes implemented American corporate governance systems but these reforms were not successful. On the contrary, they led to a notable failure (Branson, 2001). In consequence, there is remarkable trend to adapt features of the mature corporate governance systems, which will definitely lead to the creation of a new 'hybrid' model instead of an accurate convergence of national corporate governance systems.

Indeed, this prominent tendency will definitely not lead to an integral convergence system; instead, it will certainly lead to a hybrid system with Anglo-Saxon and German-Japanese

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² This includes: exports, licensing, franchising, sales subsidiaries, joint venture, turnkey projects, strategic alliances, greenfield, acquisitions, management contracts and mergers.

³ As held by Guillen: 'Corporate Governance patterns continue to differ markedly across countries in despite of decades of economic globalization and 20 years of intense financial globalization' in 'Corporate Governance and Globalization: Is there Convergence Across Countries?'

features in the context of Corporate Governance. Despite the fact there are many authors who advocate a convergence system in the future, where all the corporate governance systems will be similar to the American Corporate Governance system, they do neglect the innate cultural, political, economic, legal and religious factors that are deeply embedded in every country's corporate governance system. On the contrary, these aspects have been just seen as 'anecdotal or as black box' (Licht, 2005). In fact, the establishment and ensemble of corporate governance in any system, entails and reflects national culture (Bebchuk, cited on Licht, 2005)⁴. Moreover, as held by Licht, the formal legal rules should be in accordance with the prevailing cultural orientations in a society. Therefore, the initiative of global corporate convergence as a future model can not be considered at all, since cultural values, institutions, which are extremely rooted in every country, can not be eroded and replaced easily to adapt to completely different patterns of another corporate governance system, in particular the Anglo-Saxon model.

However, aside from the unfeasibility of the convergence of corporate systems, there are two distinctive patterns among developed countries. On the one hand, the stakeholder system, also known as the relational-insider system, dedicated-capital system and welfare capitalism (Jacoby, 2001), and on the other hand, the shareholder model, also called the Anglo-American system.

German-Japanese Model.

The former prevails in Germany and Japan and other countries such as The Netherlands and to some extent in France (Edwards, 2004). This model is essentially characterized by: the presence of a two tier board system, the management board and the supervisory organ, where the supervisory organ's main function is to control the management board (Braendle, 2005); a concentrated ownership held generally by families, banks and other corporations (Jacoby, 2001), with cross holding among investors; banks playing essential roles as creditor and controller; active protection and antipathy against the threat of hostile takeovers bids (Rhodes, 1998); and finally active participation of employees and investors in the decision making process in terms of management and in the control of companies. The latter, shareholder model, is regarded as an 'exit' model, since shareholders sell their shares as a manifestation of discontent with the management (Jacoby, 2001). This may occur as a consequence of dispersed ownership, since the large presence of shareholders makes it somewhat difficult to control the management; on the contrary, it is the external market mechanisms in charge of disciplining managers through takeover bids and mergers. In this pattern there is clear prevalence for shareholders protection rather than stakeholders such as employees, suppliers, customers and members of community.

The management and control function are both concentrated on just one organ, the board. Executive remuneration is linked to corporate performance (Tam, 2002); and finally, in contrast to the stakeholder model, the investment plans of shareholders are generally short term (Tam, 2002).

In order to analyse in detail both patterns of corporate governance systems, we will examine the pivotal features of different institutional frameworks. In this sense, it will be

⁴ The author actually refers culture to the complex of meaning, symbols, and assumptions about what is legitimate and illegitimate, good or bad. He also includes prevailing practices into the explanation.

demonstrated that it is very difficult for one corporate governance system, which has already well established features in terms of corporate governance values (according to its own cultural, politic and economic), to shift to a different model which has been result of its own cultural-political development.

First at all, **Germany** is considered as the most outstanding case of a stakeholder corporate governance system. In particular, banks in Germany actually have a large ownership and involvement in many big German firms. This is basically due to certain policies adopted by the government in order to achieve national objectives in terms of economic growth, maintenance of social stability and industrial harmony previous to the First World War. But the most relevant efforts promoted by the German government were the attempts to catch up with the industrialization process that was occurring during that time (Jacoby, 2001). The sole manner to achieve such a goal was through the active intervention and involvement of banks. Conversely, Britain did not have any bank-centred financing system nor bank-centred governance, since Britain was the first industrialized country and did not need bank an intervention system to achieve its national objectives (Jacoby, 2001). In this sense, the role of banks in the German corporate governance system has fundamentally been as a board member and also providing working capital and other services (Charkham, 2005). Moreover, the most remarkable feature, as mentioned earlier, has been banks as lenders. In that sense, banks have a tight control over management. Conversely, in the Anglo-Saxon model the banks have not been as much involved as in the stakeholder model, especially in the US, since banks are not motivated to monitor management, invest in equities, nor become an investors (except as institutional investors).

Another remarkable feature of this system is the active participation of employees in the decision making process. Their main concern in the supervisory board consists basically in the prosperity of the corporation, and a mutual relationship based on cooperation rather than confrontation (Charkham, 2005). Also, works councils must be consulted and informed in major decisions taken by the management board, such as payment, flexible working, holidays, safety at work (Miles, 2002). In certain circumstances the works councils have rights of co-determination in the case of dismissals, grievances and in the case of vocational training (Charkham, 2005). In this sense, employees are able to negotiate and discuss work conditions in difficult periods. For instance, Bayer⁵, the pharmaceutical company, got acceptance from its trade union that wages could be reduced by to up 10% (Sparrow cited on Reilly, 1998). Another similar case refers to the car maker Volkswagen, where its trade union accepted a 'pay for jobs' deal, which reduced pay by 11-15%, but in exchange decreased working hours (Reilly, 1998).

Both in Japan and Germany corporate governance systems are closely concerned with employee training and education. The system focuses its attention on the internal generation of ideas through development of human capital and enhancement of specific skills in order to increase productivity and reduce turnover. This particular point seems not to be taken into account by the Anglo-American system, where corporations rely more on the external market to generate ideas and enhance productivity rather than employer training investment. In particular, Japanese corporate governance focuses mainly on employee value rather than shareholder value, as in the Anglo-Saxon system.

⁵ The pharmaceutical company

In the German and Japanese corporate governance system there is an ostensible resistance toward hostile takeover bids to discipline management. On the contrary, this system is highly based on career development and also the managerial promotion system, especially in Japan. Also trust and long term relationships with not only employees but also banks, customers and suppliers contribute to diminish the agency problem effects. In contrast to the stakeholder model, the Anglo-Saxon system attempts to alleviate the agency problem through executive compensation schemes, inclusion of an independent board of directors (which has been regarded as superfluous) and also by the markets for corporate control, which includes hostile takeover bids and mergers (Jacoby, 2001).

Significant changes have been introduced in the German system. There has been a considerable increase in the proportion of shares held by international institutional investors from 4% to 13% between 1990 and 1998 (Edwards, 2004). The notion of 'shareholder value', as in the Anglo-Saxon model, is being common by used; a number of major German firms have begun to adopt international accounting standards. However, Germany's corporate governance system remains reluctant to change to the American model. In this respect, the Takeover Law of 2002 allows managers the introduction of anti-takeover defences; the dispersion of share ownership has just increased slightly and the numbers of listed companies have remained low by international standards (Edwards, 2004); as held by Jurgens *et al* 'there is a very narrow base for a shareholder value economy in Germany' and they argue that the 'central pillars of German corporate governance – the dominant role of banks, the system of co-determination and the company centred management system - are not crumbling (Jurgens *et al* cited on Edwards, 2004); works councils are now more willing to accept management proposals. However the basic structure of collective bargaining and codetermination continue to cover the majority of the workforce. Although the German corporate governance system has adopted some features of the Anglo-Saxon system, it does not mean that the German model is converging with the American model. It just responds to the need to adjust to the new economic order, led by neoliberal ideology and globalization⁶.

The current Chinese Corporate Governance and its development.

In **China** the corporate governance system seems to differ significantly from both systems, the Anglo-American and German-Japanese, despite the fact that the Chinese government have adopted American corporate system. First of all, Chinese corporate governance has been generally characterized by intense ownership of state-owned companies where the state has right of control, right of disposition, and right over interest and over residuals. The state, as a major shareholder in Chinese companies, takes part as a creditor, supplier, supervisor and even manager (Yuma, 2003). In this sense, the state has the intention of maintaining full control over enterprises and that generates a conflict of interest between the state and shareholders. Moreover, there is a clear absence of 'Ultimate Principal', where an agent of the state is in charge of monitoring managers of enterprises, but this manager is also monitored by another agent of the state, consequently there is an endless monitoring agent chain, where at the end of the day there is no proper monitoring. Furthermore, these agents are appointed by and receive their salary from the local

⁶ It would just be impossible to consider the German corporate governance with just one tier board, excluding employees from supervisory board and instead, focusing just on shareholder value.

government. As a result there is no real incentive for them to monitor and it generates a conflict of interest instead.

Another critical issue lies in the basis that separation between ownership (shareholders) and control (management) will lead to success and also diminish agency problems. However, this does not seem to happen in the Chinese reform, with the dual role of the Chinese government taking part as a manager and also as an organ of control (Clark, 2003). Despite the reform introduced during 1997 and 1999 (Congress of the Community Party and the Fourth Plenum of the Fifteenth CPC Central Committee, respectively) through privatization, and corporatization, the promulgation of a Code of Corporate Governance for Listed Companies and the significant changes in an effort to enhance its corporate governance, the main inconsistencies still persist. Corruption, lack of protection for shareholders rights, fraudulent dealing, lack of protection of intellectual property, weak judiciary system and tax cheating are some of the most notorious problems faced by China Corporate Governance (Tam, 2001).

Despite all these appalling circumstances, the Chinese government insists in adopting the American corporate governance model, borrowing mature institutions and modern instruments of developed countries, in order to overcome its main social, economic and political problems. It seems, however, that the national government has disregarded its own embedded cultural values based on the legacy of Confucianism, which are founded on the basic principles of collectivism, moral rightness, hierarchy, and long-termism, whereas the Anglo-Saxon model focus its foundation on individualism, profit-maximization, equality and short-termism, and from these values the American corporate governance model is created. Therefore, it is nearly impossible to change traditional institutions and instruments, in the context of corporate governance, inherent to the Chinese culture that has been governing for nearly 2500 years, to a fashionable and stylish American model. Furthermore, some scholars have maintained that Confucianism may have certain economic implications in the manner of conducting business. In this regard, there are three values central to the Confucian system: loyalty, honesty and reciprocal obligations. Likewise, Chinese values and standards will not be eroded just to install a complete innovative corporate governance. Consequently, what is occurring is merely a fusion of corporate governance systems, instead of a complete convergence toward the American model. In this sense, Chinese corporate governance has adopted features of both Anglo-Saxon and German-Japanese models that make it more in common with the German-Japanese than with the American model (Tam, 2002).

As major prominent features of the current Chinese corporate governance model, adopted from both systems, can be mentioned: financial reform that has created state-owned banks as a main finance provider for Chinese enterprises; the Chinese state and collective enterprises issued various forms of bonds and shares in order to raise funds; introduction of two official stock exchanges in Shenzhen and Shanghai. Of the 851 listed companies listed in the stock exchange, 75% were still owned by the government or state owned holding companies. Despite the fact that the number of investors has increased significantly during the last ten years, the state remains the major shareholder, holding about two thirds of the total issued shares (Tam, 2002).

As mentioned previously, the Chinese situation is highly characterized by the concentrated ownership in the hands of the state. But despite this majority ownership, the state does not

exercise a tight control or vigilance over the managements running the companies. Even worse, managers are appointed by the state itself, expressly for the Communist Party. Moreover, insider managers and their Party-ministerial associates hold the control of the company (Tam, 2002); therefore the goals and objectives are determined by the insider managers. As a result, there is no effective control over enterprises; instead the state and shareholder are poorly represented. In this context, one would pose a question: how will Chinese companies attempt to attract external investors and capital and also protect shareholders' rights?

The adoption of a two tier board model does not seem be the solution to alleviative current Chinese corporate governance failures, in the sense that this institution has been designed to operate in corporate govern system where there is a clear, separated and active participation on the one hand, of employees, suppliers and customers, and on the other hand, management. But this is not the particular case in China, where there is clear evidence of concentrated ownership by the state playing a dual role as manager and controller agent. Again, how will the Chinese state attempt to control and reduce agency problems without a real definition of both management and supervisory board roles? Even more, there is no of effective system of corporate control, neither through external market regulation (takeover bids and mergers) nor through executive remuneration linked to corporate performance. In respect of hostile takeovers in China, there is an extreme scepticism towards this form of disciplining the management. For instance, Shanda, China's top 10 companies snapped up 19.5% of Cina.com, one of the largest Web portals in China. However, Cina.com through poison pills issued more stock in order to dilute the shareholder's stake⁷ (The economist, 2005).

There is also a substantial confusion related to the actual meaning of corporate governance in China. The concept is actually understood by Chinese managers as just standards and measures of administration and supervision, or even more just as a modern way of organizational management (Tam, 2002). This point raises another matter that needs consideration on the basis that if Chinese managers do not even comprehend the real connotation that corporate governance embraces, how can they pretend to develop and create an appropriate system compatible with its economic, social and political institutions?

An important question may arise after the previous presentation regarding major changes in Chinese corporate governance. How has China done so well so far? This is basically due to two fundamental factors: a huge and cheap workforce and its economy is usually open to trade (The Economist, 2005). Having China joining the WTO and also having adopted strategic capabilities such as becoming more competitive, achieves economies of scale, reduces operational cost, enables geographical expansion, enhances efficiency and optimises use and administration of assets and reduction of overheads, improves levels of labour productivity, increases profitability by reaping the cost reductions that come from experience curve effects and location economies (Hill, 2005) have led to a massive economic growth of nearly 9% per year (Financial Times, 2005).

⁷ Defence proper of the German-Japanese system.

Japanese Corporate Governance System

The **Japanese** corporate governance system, as mentioned above, is another clear example of the stakeholder system. However, this can be differentiated from the German system on the basis of the presence of Keiretsu as a network of interdependent companies. Its main features consist of common shareholding, exchanges of information, development and sharing of business experience and know how, mutual financial assistance, reciprocal trading relations and corporate management assistance, and all companies involved within the keiretsu have a central bank (Miles, 2002 and Charkham, 2005). This kind of organization can be found as vertical and horizontal keiretsu. The former refers to a group of companies in the same industry; for instance, Toyota the car manufacture has an electrical supplier, steel supplier inside its own keiretsu. While the latter consists basically of groups of companies in different industries.

The concept of keiretsu emerged after the Second World War as a measure against anti monopoly rules imposed by the US. Moreover, it was created in order to protect Japanese companies against hostile takeover bids, improve productivity, secure funds in the event of shortage and create business stability (Miles, 2003). The cross-shareholding among companies, though small, allows them to exercise long-term relationships with other companies within the keiretsu. Also, the keiretsu allows companies to disclose information to other companies, in particular the joint venture manufacturing, and a monitoring function of companies over others, since there are cross-shareholdings. The role of the banks in the keiretsu is really significant, since they do not just serve as lenders or capital providers but also are also a source of practical advice when companies within the keiretsu are experimenting financial difficulties. In addition, their role may go further. For instance, if a company is underperforming the main bank is able to takeover the business, decide whether it continues trading or even send it into liquidation (Miles, 2003).

Despite the undoubted success of the keiretsu during the decades of the 1970s and 1980s, it does seem that keiretsu ties have begun to weaken. Since the last decade, the numbers of keiretsu have diminished from 6 to 4. The proportion of cross-shareholding has fallen from 43% to 30% between 1988 and 2003, (The Economist, 2003). In addition, recent developments in Japanese corporate governance have led to the adoption of some institutions of the Anglo-Saxon system and the notion of keiretsu has started to erode. First of all, the banks' role has switched from its paternalist context of unconditional lenders and management monitor to the point of discriminating their customers into four main groups: 1. Those whose relationship they wish to improve; 2. Those whose relationship they want to preserve; 3. Those to whom they want to reduce commitment, and 4. Those they want to leave altogether (Charkham, 2005).

As a consequence of advanced development and globalization, not convergence toward a common model, Japan has introduced new practices into its corporate governance. In this sense, the repurchase of shares is now allowed, since this common instrument had been prohibited in Japan. Despite the fact that stock options were introduced in Japan in 2001, its availability has still been restricted. However, since 2001 this common practice has been deregulated and nowadays this concept embodies two main features: wide provision, but only small percentage of salaries (Miles, 2003). The concept of holding company had been abolished after the Second World War. However, from 2002 this system was re-established. Share for share among companies was introduced in order to facilitate

creation of holding companies and wholly owned subsidiaries. Also the role of auditors was strengthened in the reform of 2001. Now, the law requires 'real' auditors, since in the past companies were limited to appointing ex-employees in the position of external auditor (Shishido, 2004 and Milhaupt, 2004).

One of the most remarkable features introduced in the Japanese system refers to the adoption of the board with committees as a typical institution of the Anglo-Saxon model. In the traditional Japanese model, the board was monitored just by the external auditors who were responsible for investigating illegal directors' performance. In this sense there is no real demarcation between management and control organs in Japanese corporate governance. At present, with the adoption of a board with committees system, there is visible separation between management and control organs. Also the outside directors must be a majority in the committees (audit, nomination, and remuneration) and, finally, the board of director can now delegate several of its main functions to the management. As result the board can focus more on substantial management issues (Shishido, 2004).

Although all these recent innovations, introduced in the Chinese, German and Japanese systems in order to enhance the local economy and improve the effectiveness of their corporate governance institutions, can not therefore be considered as a swift move towards convergence, they must be seen as a consequence of globalization. Advocates of convergence of national corporate governance systems ignore completely the cultural⁸ implications that determine the creation of each particular corporate governance system in each country. Given institutional complementarities and path dependence, it is difficult for one country to borrow a particular practice and expect it to perform similarly when transplanted to a different context (Jacoby, 2001). If the recent US economic prosperity were for its corporate governance system, countries with the same system would be expected to perform with the same prosperity. However, this is not case. Britain had just low economic growth (measured GDP) during the 1970s and 1980s, while Japan and Germany performed splendidly during the same period, despite their governance models (Jacoby, 2002). Moreover, external factors have affected economic performance in those countries: first Germany has spent heavily in the unification process with the East, whereas Japan has been dealing with a major issue arising from government's macro-mismanagement and banking problems. Therefore, each county is shaping and adopting institutions and instruments from mature corporate governance to enhance their main basic needs in terms of internal corporate structure. Thus, we will see in the future a 'hybrid' model as the combination of typical features of corporate governance of every country with Anglo-American characteristics', rather than a converged corporate governance model.

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⁸ According to Amir Licht 'culture refers to the complex of meaning, symbols, and assumptions about what is good or bad, legitimate or illegitimate that underlie the prevailing practices and norms in a society', from this perspective every country has a different cultural values which serves as basis to establish of its own legal system that consequently differ from to each country.

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