# The Corporate Governance Review

Tenth Edition

**Editor**
Willem J L Calkoen

The Law Reviews

# THE CORPORATE GOVERNANCE REVIEW

TENTH EDITION

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**Editor**
Willem J L Calkoen

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# PREFACE

I am proud to present this new edition of *The Corporate Governance Review* to you.

In this 10th edition, we can see that corporate governance is becoming a more vital and all-encompassing topic with each year that passes. We all realise that the modern corporation is one of the most ingenious concepts ever devised. Our lives are dominated by corporations. We eat and breathe through them, we travel with them, we are entertained by them, most of us work for them. Most corporations aim to add value to society, and they very often do. There is increasing emphasis on this. Some, however, are exploiting, polluting, poisoning and impoverishing us. A lot depends on the commitment, direction and aims of a corporation's founders, shareholders, boards and management, and employees. Do they show commitment to all stakeholders and to long-term shareholders, or mainly to short-term shareholders? There are many variations on the structure of corporations and boards within each country and between countries. All will agree that much depends on the personalities and commitment of the persons of influence in the corporation.

We see that everyone wants to be involved in better corporate governance: parliaments, governments, the European Commission, the US Securities and Exchange Commission (SEC), the Organisation for Economic Co-operation and Development (OECD), the UN's Ruggie reports, the media, supervising national banks, more and more shareholder activists, proxy advisory firms, the Business Roundtable and all stakeholders. The business world is getting more complex and overregulated, and there are more black swans, while good strategies can quite quickly become outdated. Most directors are working very diligently. Nevertheless, there have been failures in some sectors and trust must be regained. How can directors do all their increasingly complex work and communicate with all the parties mentioned above?

What should executive directors know? What should non-executive directors know? What systems should they set up for better enterprise risk management? How can chairs create a balance against imperial CEOs? Can lead or senior directors create sufficient balance? Should most non-executive directors understand the business? How much time should they spend on their function? How independent must they be? Is diversity actively being pursued? Is the remuneration policy defendable? What are the stewardship responsibilities of shareholders? What are the pros and cons of shareholder rights plans and takeover defences?

Governments, the European Commission and the SEC are all pressing for more formal inflexible legislative acts, especially in the area of remuneration. Acts set minimum standards, while codes of best practice set aspirational standards. We see a large influence on norms by codes and influential investor groups.

More international investors, the Business Roundtable, voting advisory associations and shareholder activists want to be involved in dialogue with boards about strategy, succession and income. Indeed, far-sighted boards have 'selected engagements' with stewardship shareholders to create trust. What more can they do to show all stakeholders that they are improving their enterprises other than through setting a better tone from the top? Should they put big signs on their buildings emphasising integrity, stewardship and respect?

Interest in corporate governance has been increasing since 1992, when shareholder activists forced out the CEO at General Motors and the first corporate governance code – the Cadbury Code – was written. The OECD produced a model code, and many countries produced national versions along the lines of the Cadbury comply or explain model. This has generally led to more transparency, accountability, fairness and responsibility. However, there have been instances where CEOs have gradually amassed too much power, or companies have not developed new strategies and have incurred bad results – and sometimes even failure. More are failing since the global financial crisis than before, hence the increased outside interest in legislation, further supervision and new corporate governance codes for boards, and stewardship codes for shareholders and shareholder activists. The European Commission is developing regulation for this area as well. Recently, we see that governments want to involve themselves in defending national companies against takeovers by foreign enterprises. We also see a strong movement of green investors, which often is well appreciated by directors. There is a move to corporate citizenship. The Business Roundtable with about 180 signatories has confirmed to embrace stakeholder corporate governance.

This all implies that executive and non-executive directors should work harder and more as a team on long-term policy, strategy, entrepreneurship and investment in R&D. More money is lost through lax or poor directorship than through mistakes. On the other hand, corporate risk management with new risks entering such a digitalised world and cybercrime is an essential part of directors' responsibilities, as is the tone from the top. How can directors do their important work well without being petrified of attacks from shareholders, regulations and the press?

Each country has its own measures; however, the chapters of this book also show a convergence. Understanding differences leads to harmony. The concept underlying the book is that of a one-volume text containing a series of reasonably short, but sufficiently detailed, jurisdictional overviews that permit convenient comparisons, where a quick first look at key issues would be helpful to general counsel and their clients.

My aim as editor has been to achieve a high quality of content so that *The Corporate Governance Review* will be seen as an essential reference work in our field. To meet the all-important content quality objective, it was a condition *sine qua non* to attract as contributors colleagues who are among the recognised leaders in the field of corporate governance law from each jurisdiction.

I thank all the contributors who helped with this project. I hope that this book will give the reader food for thought; you always learn about your own law and best practice by reading about the laws and practices of others. Further editions of this work will obviously benefit from the thoughts and suggestions of our readers. We will be extremely grateful to receive comments and proposals on how we might improve the next edition.

**Willem J L Calkoen**
NautaDutilh
Rotterdam
March 2020

Chapter 12

# JAPAN

*Mitsuhiro Harada, Tatsuya Nakayama and Yohei Omata*[1]

## I OVERVIEW OF GOVERNANCE REGIME

### i Sources of law and enforcement

Companies in Japan are generally regulated by the Companies Act.[2] Further, listed companies in Japan are also regulated by the Financial Instruments and Exchange Law (FIEL)[3] and the Securities Listing Regulations published by each securities exchange (SLRs). As the securities exchanges, in publishing their SLRs, generally follow the SLRs published by the Tokyo Stock Exchange (TSE), which is the largest securities exchange in Japan, the information we provide hereafter focuses on the SLRs published by the TSE, and references to 'SLRs' are to the SLRs published by the TSE.

In the event that a company violates the Companies Act, depending on the specific provision that is violated, shareholders or creditors of a company are generally entitled to bring a lawsuit against the company. The Financial Services Agency of Japan is responsible for enforcing the FIEL and, depending on the specific provision that is violated, may levy monetary fines, prison sentences, or even both, in connection with certain violations thereof. SLRs are enforced by the specific securities exchange that published the applicable SLR. Violations of the SLRs generally lead to the securities exchange requiring that company to submit an improvement plan. In extreme cases, securities exchanges may even delist the shares of the company.

### ii Nature and recent developments in the corporate governance regime

The Companies Act, which has been in effect since 2006, allows a company some flexibility with its governance organisation, such as whether to have a board of directors and whether to have a corporate auditor. Revisions to the SLRs on 30 December 2009, however, require a listed company to have one or more independent directors or corporate auditors (i.e., outside directors or corporate auditors (as defined below) who are not likely to have a conflict of interest with the company's shareholders). If an independent director or corporate auditor has business or other relationships with the company (e.g., if the director or corporate auditor is a main business partner, consultant or a major shareholder of the company), this relationship must be disclosed, and the reasons the person was appointed as an independent director or corporate auditor must also be provided in the company's corporate governance reports

1 Mitsuhiro Harada and Tatsuya Nakayama are partners and Yohei Omata is a senior associate at Nishimura & Asahi.

2 Act No. 86 of 26 July 2005.

3 Act No. 25 of 13 April 1948.

under the SLRs. Further, the Companies Act reform bill was enacted on 1 May 2015, and the Reform Act of 2015 states that if a large public company that is required under the FIEL to file a securities report does not have an outside director, it must explain the reason for this in its business report and upon its annual shareholders' meeting; in addition, the Companies Act reform bill which passed the Diet on December 2019, but has not yet been put in force[4], requires a large public company that is required under the FIEL to file a securities report to have one or more outside directors. On 5 February 2014, the TSE announced a revision to the SLRs requesting that listed companies make efforts to elect at least one independent director because, in practice, most listed companies had elected an independent corporate auditor. In addition, the TSE released Japan's Corporate Governance Code (Code) on 1 June 2015 which was most recently revised on 1 June 2018.[5] The Code, which is applicable to all companies listed on securities exchanges in Japan, establishes fundamental principles for effective corporate governance, including a structure for transparent, fair, timely and decisive decision-making by companies, which pay due attention to the needs and perspectives of shareholders and also customers, employees and local communities. The Code stipulates that listed companies should appoint at least two independent directors, and that listed companies should examine whether the purpose of cross-shareholdings is appropriate, and whether the benefits and risks from each holding cover the company's cost of capital.

In Japan, roughly speaking, there were two types of governance systems prior to enactment of the Reform Act of 2015: a company with a corporate auditor and a company with committees.[6] In a company with a corporate auditor, the corporate auditor is an organisation that audits the directors' execution of their duties. This type of organisation is the primary type of company in Japan. On the other hand, in a company with committees (without a corporate auditor), three stipulated committees perform auditing and monitoring functions: a nominating committee that decides on the agenda of nominating or dismissing directors at shareholders' meetings; an audit committee that audits the execution of duties of executive officers and directors; and a compensation committee that determines compensation for each executive officer and director.

A majority of each of these committees must consist of outside directors. In a company with committees, because a board may delegate substantial parts of its decision-making authority over the management of the company to the executive officers, the board is expected to monitor the execution of the executive officers' duties rather than to make decisions (although a director can serve concurrently as an executive officer). This type of organisation was first introduced in 2003 and is used only by a limited number of large companies in Japan.

The Reform Act of 2015 further introduced another type of governance structure – a company with an audit committee – anticipating that this structure makes it easier for Japanese companies to select a monitoring model involving outside directors. A reduction of costs for selecting the monitoring model is achieved by decreasing the number of outsiders (i.e., outside directors and outside corporate auditors). A company with an audit committee

4 This Companies Act reform bill will be put into force on the day designated by cabinet order within one and a half years from the time of promulgation (i.e. December 11, 2019).

5 The Code is available at www.jpx.co.jp/english/equities/listing/cg/tvdivq0000008jdy-att/20180601.pdf.

6 Following enactment of the Reform Act of 2015, companies with committees are now called companies with nominating committee, etc., but the meaning of the term is unchanged. As a matter of convenience, we hereinafter refer to this type of company as a 'company with committees'.

is not required to possess a nominating committee or compensation committee. The audit committee must have more than three directors as members, and the majority of them must be outside directors.

The number of companies with an audit committee has reached more than 1,000, which is almost equal to one-third of the total number of listed companies in Japan. This is because, as previously discussed, being a company with an audit committee makes it possible for a listed company with a board of corporate auditors to decrease the number of outsiders. While the Code stipulates that a listed company should appoint at least two independent directors, if a listed company has a board of corporate auditors, half or more of the corporate auditors need to be outside corporate auditors under the Companies Act. If a company with a board of corporate auditors transforms into a company with an audit committee, such requirement to retain outside corporate auditors would not be applicable.

## II CORPORATE LEADERSHIP

### i Board structure and practices

#### *Structure and composition of the board*

Japanese companies generally use a one-tier board structure. Under the Companies Act, although a company may choose not to have a board of directors, the typical form of management structure is a company with a board of directors, where the board has decision-making authority. In a company without a board of directors, while there is no board, unless otherwise provided in the company's articles of incorporation (articles), a majority of the directors will decide business matters on behalf of the company. As compared with a company with a board of directors, however, shareholders of a company without a board have broader decision-making authority, such as the ability to approve certain competitive activities or to approve activities that result in conflicts of interest of directors.

A company with a board of directors is required to have three or more directors. A company without a board, on the other hand, is required to have only one or more directors. A company with committees must also have a board, and therefore it is required to have three or more directors. A company with an audit committee is required to have a board as well, and therefore to have three or more directors. In addition, in a company with an audit committee, the audit committee must have more than three directors as members, and the majority of them must be outside directors. In Japan, no director is required to be a representative of the employees of the company.

#### *Legal responsibilities of the board*

Except for a company with committees and a company with an audit committee, a company with a board of directors generally must have a corporate auditor. In a company with a corporate auditor and a board of directors, the board has decision-making authority over the management of the company, and representative directors and other executive directors are responsible for executing the company management decisions. The corporate auditor generally audits the execution of duties by directors, with a view to compliance with law.

In a company with committees, while the board may have decision-making authority over the management of the company, it usually delegates substantial portions of this authority to executive officers, and executive officers are responsible for executing the company management decisions. Accordingly, for example, executive officers may be delegated the authority to decide on the acquisition of important assets, incurrence of significant debt, appointment of important employees and establishment of important organisational changes, while those are items that would be determined by a board of directors in a company with a corporate auditor. The board of a company with committees would then, inter alia, determine the agendas of shareholders' meetings, approve competitive activities and activities that result in conflicts of interests of directors, and appoint committee members. The audit committee audits the execution of duties by directors with a view not only to compliance with the applicable laws, but also the appropriate performance of their duties.

In a company with an audit committee, the core role of the board of directors is to set the basic management policy, develop the internal control system, and supervise the execution of business by other directors, including representative directors and other executive directors. Although important business decisions, such as disposing of or acquiring important assets, are required to be made by the board of directors, its shareholders can, through the company's articles, enable the board to delegate these decisions to individual directors, such as representative directors or other executive directors. In addition, if the majority of the board is held by outside directors, the board can delegate these decisions to individual directors, such as representative directors or other executive directors.

***Delegation of responsibilities***

In a company with a corporate auditor and a board of directors (which is typical of Japanese companies), the board often delegates decisions on certain matters regarding day-to-day operations to individual directors, such as representative directors or other executive directors. However, the board may not delegate certain important company matters to individual directors, including:

*a* disposing of or acquiring important assets;
*b* incurring significant debts;
*c* electing or dismissing important employees, including managers;
*d* issuing shares at a fair price; and
*e* approving audited financial statements.

In a company with committees, the nominating, audit and compensation committees each have their own authority under the Companies Act and cannot further delegate substantial parts of their responsibilities. Apart from the committees' responsibilities, the board has sole decision-making authority over the management of the company with respect to certain matters, which include basic management policy; matters necessary for the execution of the audit committee's duties; and if there are two or more executive officers, matters relating to the interrelationship between executive officers.

Similarly, in a company with an audit committee, the audit committee has its own authority and cannot further delegate a substantial part of its responsibility. Apart from the audit committee's responsibility, the board has sole decision-making authority over the management of the company with respect to certain matters, which include basic management policy; and matters necessary for the execution of the audit committee's duties.

A board of directors in a company with committees often delegates decision-making authority over the management of the company to the executive officers (as described above). The board may not, however, delegate certain important matters (in addition to the above-mentioned matters) to executive officers (or to individual directors, because each individual director who does not double as an executive officer in a company with committees generally does not have decision-making authority), including:

*a* approval of share transfers (if the company is a closed company);
*b* holding of shareholders' meetings;
*c* appointment or removal of committee members;
*d* election or dismissal of executive officers; and
*e* determining the contents of agreements for mergers, demergers or share exchanges.

In a company with an audit committee, although important business decisions such as disposing of or acquiring important assets are required to be made by the board of directors, its shareholders can, through the articles, enable the board to delegate these decisions to individual directors, such as representative directors or other executive directors. If the majority of the board is held by outside directors, the board can also delegate these decisions to individual directors, such as representative directors or other executive directors.

In Japan, normally the board appoints the CEO or its equivalent from among its representative directors (in the cases of a company with a corporate auditor and a board of directors, and a company with an audit committee) or representative executive officers (in the case of a company with committees). Generally, the CEO will chair the board meeting, and will perform the role of chair of the board in this sense.

***Remuneration of directors and executive officers***

In a company with a corporate auditor and a board of directors, the aggregate amount of remuneration of all directors is determined at a shareholders' meeting (if not provided in the articles), and the board determines the remuneration of each director within the parameters of this aggregate amount; the board can delegate this authority to an individual director, typically the CEO. The same would apply to a company with an audit committee. In addition, in a company with an audit committee, the audit committee is given the power to express its view on the election, dismissal, resignation and compensation of other directors at the shareholders' meeting so that the shareholders can make an informed decision on these matters. The Companies Act reform bill, which passed the Diet on December 2019, but has not yet been put in force, requires (1) a large public company that is required under the FIEL to file a securities report; and (2) a company with an audit committee to establish company's policies for determination of the remuneration for each director, except for in the case where the remuneration for each director is determined by a shareholders' meeting or the articles.

On the other hand, in a company with committees, the compensation committee determines the remuneration of each director and executive officer in accordance with the remuneration policy prescribed by the committee (therefore, shareholders' approval is not required).

A public company (i.e., a company, typically listed, whose articles do not require, as a feature of all or part of its shares, the company's approval for any transfer of those shares, whether it is a company with a corporate auditor, a company with an audit committee or a company with committees) must disclose the aggregate remuneration of all of its directors, corporate auditors and executive officers to its shareholders in its business report.[7] In addition, a listed company must disclose the following information in its securities report: (1) the

7 Currently, in order to improve the level of disclosure regarding the remuneration of directors, corporate auditors and executive officers, requiring a public company to disclose the following items in its business report is being discussed: (1) an item regarding a policy for determining the remuneration, (2) an item regarding a resolution of shareholders' meeting for the remuneration, (3) an item regarding a delegation of

amount of remuneration and a breakdown by type of payment (e.g., fixed compensation, performance-based compensation or retirement payment) for each director, corporate auditor and executive officer if his or her remuneration for the relevant fiscal year is ¥100 million or more (out of 2,411 companies listed as of 10 July 2019, there were 570 directors, corporate auditors or executive officers who received ¥100 million or more as remuneration for the fiscal year ending March 2019); (2) an explanation of the company's policies for determining an amount of or calculation method for remuneration of directors, corporate auditors and executive officers; as for a company that pays directors, corporate auditors or executive officers performance-based compensation, an explanation of the company's policies on the payment ratio of performance-based compensation and non performance-based compensation (if any), indicators for performance-based compensation and reasons why the company chose such indicators, how the amount of performance-based compensation was determined, and the targets and performance for such indicators in the most recent fiscal year; (3) the name of a person or organisation who has the authority to determine an amount of or calculation method for remuneration of directors, corporate auditors and executive officers, an explanation of such authority including its range of discretion; and (4) as for a company with a committee, including an optional committee, which involves the establishment of company's policies for determination of an amount of or calculation method for remuneration of directors, corporate auditors or executive officers, an outline of procedures for involvement of such committee and activities of the board and such committee in the course of determination of an amount of remuneration of directors, corporate auditors and executive officers in a most recent fiscal year.

The Code stipulates that, in addition to making information disclosure in compliance with relevant laws and regulations, listed companies should disclose and proactively provide information regarding their boards' policies and procedures for determining the remuneration of senior management and directors to enhance transparency and fairness in decision-making and ensure effective corporate governance.

***Board and company practice in takeovers***

The typical anti-takeover measure listed companies in Japan use is a 'precaution-type anti-takeover measure',[8] whereby a company announces a takeover process rule but does not issue any securities at first. Although there are many variations of this measure, generally a company announces in advance a certain takeover process rule to the effect that a takeover bidder must provide sufficient information to a board of directors about the bidder and the terms of its bid before the beginning of its takeover, and the bidder refrains from purchasing the shares of the company unless the board of the company completes its analysis of the terms of the bid (but the analysis by the board must be completed within a certain period, such as 60 days). If these procedures are respected by the bidder, the board will not implement anti-takeover measures, but where the board decides that the value of the company would be damaged, or maximising value would be difficult under the takeover (including if the bidder

authority to determine the remuneration by a resolution of the board of directors, (4) an item regarding performance-based compensation, (5) an item regarding stock options, and (6) a breakdown by type of payment of the aggregate remuneration.

8 The Code stipulates that anti-takeover measures must not have any objective associated with entrenchment of the management or the board.

does not comply with the procedures), usually based on analysis by a third-party committee, certain anti-takeover measures may be implemented, typically the issuance of share purchase warrants free of charge to all shareholders that cannot be exercised by the bidder.

In Japan, the *Bull-Dog Sauce* case[9] was the first case where actual share purchase warrants were issued to shareholders as an anti-takeover measure. In this case, the Supreme Court found that the decision regarding whether control by a specific shareholder would harm the value of the company or damage the common interests of shareholders should be ultimately determined by the shareholders who hold its corporate value, and that if, at a shareholders' meeting, the shareholders decide that the takeover would harm the value of the company or damage the common interests of the shareholders, that decision should be respected. In this case, because the issuance of share purchase warrants was approved by more than 80 per cent of the voting rights, the Supreme Court found that the issuance was valid.

Since this case, we have seen fewer attempts at hostile acquisition.[10] In addition, a tender offer regulation under the FIEL was amended in 2007 to the effect that the offeror must disclose more information prior to the tender offer, and that the target company has the right to issue a questionnaire to the offeror. As a result, the total number of listed companies that have adopted anti-takeover measures has decreased for 11 consecutive years (from 570 companies at the end of July 2008 to 327 companies at the end of November 2019).

### ii Directors

#### *Appointment, nomination, term of office*

Directors are elected by a resolution at a shareholders' meeting. In a company with a corporate auditor and a board of directors, the board generally nominates directors to two-year terms of office (maximum; however, in a closed company, the term of office may be extended until the conclusion of the annual shareholders' meeting for the last fiscal year, which ends within 10 years from the time of its election). On the other hand, in a company with committees, the nominating committee nominates directors with one-year terms of office (maximum). Further, in a company with an audit committee, a director who is a member of the audit committee must be nominated separately from the other directors, and the statutory maximum term of office for a director who is a member of an audit committee is two years, while for other directors it is one year.

Directors can be dismissed at any time by a resolution at a shareholders' meeting. Directors can seek damages for dismissal from the company if they are dismissed without justifiable grounds.

9 Supreme Court, 7 August 2007.

10 For example, in November 2012, PGM Holdings commenced a hostile takeover bid against Accordia Golf, but the tender offer failed to acquire 20 per cent of the shares. In March 2013, Cerberus Capital Management, LP (Cerberus) commenced a hostile takeover bid against Seibu Holdings Inc, but Cerberus only acquired 3.26 per cent (originally it held 32.22 per cent and ended up holding 35.48 per cent) through the tender offer. In December 2014, Prospect Co, Ltd commenced a hostile takeover bid against Yutaka Shoji Co, Ltd, but the tender offer failed to acquire 51 per cent of the shares. In April 2018, Japan Asia Group Limited commenced a hostile takeover bid against Sanyo Homes Corporation, but Japan Asia Group Limited only acquired 8.76 per cent (originally it held 4 per cent and ended up holding 12.76 per cent) through the tender offer. In July 2019, HIS Co., Ltd. commenced a hostile takeover bid against UNIZO Holdings Company, Limited, but HIS Co., Ltd. could not acquire any shares through the tender offer.

### *Liability of directors*

Generally, directors must perform their duties with the duty of care of a prudent manager in compliance with all laws and regulations, and the articles and resolutions of shareholders' meetings, in a loyal manner.

In addition to the foregoing, in Japan the business judgement rule is applied when considering whether a certain decision of a director complies with the director's duty of care as a prudent manager to the company. Under the business judgement rule, even if a director has made a certain decision that has resulted in damage to the company, the director is, in principle, deemed to have complied with his or her duty of care of a prudent manager, unless the director made important and careless mistakes in the recognition of facts, or the process and content of the director's decision-making is particularly unreasonable or improper as determined by a management expert. Nevertheless, the courts are not likely to apply the business judgement rule in cases where it can be shown that the director has a conflict of interest.

In the *Apamanshop* case,[11] the business judgement rule was affirmed by the Supreme Court. In this case, Apamanshop Holdings bought out the subsidiary's minority shareholders at a price per share higher than that set forth in the valuation report to make the subsidiary its wholly owned subsidiary. The Court cited the business judgement rule in finding that the directors of Apamanshop Holdings did not breach their duty of care, because a smooth purchase of the minority shareholders' shares was beneficial in maintaining good relationships with Apamanshop's member shops who were shareholders of Apamanshop, the corporate value of the subsidiary after the restructuring was expected to increase and the decision-making process employed by Apamanshop's directors (i.e., the management committee convened to discuss the purchase and a legal opinion was obtained) was not found to be unreasonable.

### *Role and involvement of outside directors*

Outside directors are defined under the Companies Act as directors who are not serving and who have not previously (generally for the past 10 years) served as executive directors, executive officers or employees (including managers) of the relevant company or any of its subsidiaries, its parent companies or its sibling companies. In a company with committees, a majority of the members of each committee must be outside directors, with each committee required to consist of at least three members. In a company with an audit committee, the audit committee must have more than three directors as members, and the majority of them must be outside directors. On the other hand, in a company with a corporate auditor and a board of directors, currently there are no such outside director requirements concerning board composition; however, the Companies Act reform bill, which passed the Diet on December 2019, but has not yet been put in force, requires a large public company that is required under the FIEL to file a securities report to have one or more outside directors.

The TSE requires listed companies to have one or more independent directors or corporate auditors (see Section I). Therefore, it is considered that, for example, persons who work for a company's parent company or its business partner, or consultants who receive significant fees from a company, cannot be independent directors or corporate auditors of the company. Further, on 5 February 2014, after submission of the Companies Act reform bill (which states that if a large public company that is required under the FIEL to file a securities

11 Supreme Court, 15 July 2010.

report does not have an outside director, it must explain the reason why in its business report and at its annual shareholders' meeting), the TSE announced a revision to the SLRs that requests that listed companies make efforts to elect at least one independent director (see Section I).

The Code stipulates that if the organisational structure of a company is either that of a company with a corporate auditor and a board of directors, or a company with an audit committee, and independent directors do not constitute a majority of the board, to strengthen the independence, objectivity and accountability of board functions in matters of nomination and remuneration of the senior management and directors, the company should seek appropriate involvement and advice from independent directors in the consideration of such important matters as nominations and remuneration by establishing independent advisory committees under the board, such as an optional nomination committee and an optional remuneration committee, to which independent directors make significant contributions.

***Legal duties and best practice for outside directors***

The legal duties of non executive directors including outside directors are generally the same as those of other directors or executive officers. Where provided for in a company's articles, however, the company may contractually limit the liability (to the company) of its non executive directors, including outside directors who are not aware of the wrongdoing and not grossly negligent in performing their duties to the extent of the larger of both an amount determined in advance, within the range provided in the articles, and an amount equal to double his or her annual remuneration.

Outside directors generally should review the performance of management, conflict of interest issues, the process and propriety of management decisions and general compliance, and work to improve the corporate culture. Although other directors should take on these roles as well, outside directors are expected to do so more effectively because of their objective position.

Recently, many companies in Japan have organised third-party committees to audit or review conflict of interest issues, such as management buyout transactions, internal investigations and anti-takeover measures, and an outside director is often included as a member of the committee.

In a company with a corporate auditor and a board of directors, a company with committees or a company with an audit committee, if a director intends to carry out any transactions involving a conflict of interest, approval must be obtained at a board meeting in which that director may not participate. At the board meeting, the potentially conflicted director must disclose material facts about the transaction. After the transaction, the director must also report material facts about the transaction to the board without delay.

In addition, in a company with an audit committee, an *ex ante* approval by the audit committee of a self-dealing transaction between a director and the company has the effect of switching the burden of proof regarding the violation of a director's duty from the director to the plaintiff shareholders.

### iii Auditors

In a company with a corporate auditor, the corporate auditor audits the execution of the directors' duties, including preparation of financial statements. If a company has a board of corporate auditors, the company is required to have three or more corporate auditors, and half or more of them must be outside corporate auditors. To ensure the independence of the corporate auditor, its term of office must continue until the conclusion of the annual shareholders' meeting for the last fiscal year, which ends within four years from the time of its election (in a closed company, the term of office may be extended until the conclusion of the annual shareholders' meeting for the last fiscal year, which ends within 10 years from the time of its election). On the other hand, a company with committees does not have a corporate auditor. Instead, the audit committee, which consists of directors whose terms of office are one year (maximum), audits the execution of directors' duties, including preparation of financial statements (see Section II). Similarly, a company with an audit committee does not have a corporate auditor. In a company with an audit committee, which consists of directors whose terms of office are two years (maximum), the audit committee is responsible for auditing the execution of directors' duties, including preparation of financial statements.

In addition, a large company (i.e., a company with either stated capital in the balance sheet at the end of the most recent fiscal year of ¥500 million or more, or total liabilities as of the end of its most recent fiscal year of ¥20 billion or more) and a company with committees are required to have an accounting auditor, which must be either a certified public accountant or an audit firm. An accounting auditor's terms of office must continue until the conclusion of the annual shareholders' meeting for the last fiscal year, which ends within one year from the time of their election.

To ensure the independence of corporate auditors, the following are given the power to determine the contents of proposals regarding the election and dismissal of accounting auditors to be submitted to a shareholders' meeting: a corporate auditor or a board of corporate auditors in a company with a corporate auditor, an audit committee in a company with committees and an audit committee in a company with an audit committee.

## III DISCLOSURE

### i Financial reporting and accountability

A representative director or representative executive officer must prepare a financial statement within three months from the end of each business year. A large company that is required to file a securities report under the FIEL (e.g., a listed company or a company with at least 1,000 shareholders as of the end of any fiscal year within the past five years is required to file a securities report) must prepare a consolidated financial statement under the Companies Act. However, the FIEL requires all listed companies to prepare a securities report that includes consolidated financial statements (unless they do not have any subsidiaries to be consolidated under the FIEL), as well as a quarterly report. In addition, a representative director or representative executive officer of a listed company must submit a confirmation letter as an attachment to its securities report or other reports, in which he or she confirms that the description of the report is written properly in accordance with the FIEL.

A company with a board of directors must attach financial statements and business reports to the convocation notice of its annual shareholders' meeting. The company must also keep those documents at its head office for five years, beginning two weeks (one week, in the case of a company without a board) prior to the date of the shareholders' meeting. Under the FIEL, a listed company is required to file its securities report within three months of the end of its fiscal year.

### ii Communications with shareholders

Under the Companies Act, directors, corporate auditors and executive officers must sufficiently explain the specific issues related to the agenda of the shareholders' meeting if an enquiry is made by a shareholder. In addition, to improve investor relations, Q&A sessions during shareholders' meetings are now actively encouraged in Japan. Furthermore, Japanese listed companies often hold informal meetings with investors about financial statements and related issues.[12]

## IV CORPORATE RESPONSIBILITY

### i Internal control

Boards of large companies must develop internal control systems that ensure that directors comply with the laws and the company articles, and that company operations are appropriate. On the other hand, there is no legal requirement for internal control systems for companies that are not categorised as large companies or companies that do not have a board of directors.

Additionally, in a company with committees, regardless of its size, the board must develop internal control systems that ensure that executive officers comply with the laws and the articles, and that company operations are appropriate. A listed company must file internal control reports that describe the systems that are in place to ensure that the financial reports of the company are properly made in compliance with the laws.

Similarly, in a company with an audit committee, regardless of its size, the board must develop internal control systems that ensure that directors comply with laws and the company articles, and that company operations are appropriate.

Specific contents of internal control systems may be decided at the discretion of companies. In its internal control rules, a company often provides general matters related to the control of information and documents; crisis management systems; necessary internal rules and organisations; and compliance programmes, etcetera.

Under the Whistle-blower Protection Act, the employer of a whistle-blower is prohibited from treating the whistle-blower in any disadvantageous manner, such as by demotion or reducing his or her salary, if this is in response to the employee's whistle-blowing.[13]

### ii Corporate social responsibility to employees and wider society

In Japan, a company is required to hire a certain number of persons with a disability and to take measures to continue to employ elderly persons under affirmative action-related laws. Activities related to corporate social responsibility by some companies involve actions to be taken in the interests of their stakeholders, such as preserving the environment, supporting volunteer work and creating jobs, although these are not generally required by law.

12 The Code stipulates that listed companies should, proactively and to the extent reasonable, respond to requests from shareholders to engage in dialogue so as to support sustainable growth and increase corporate value over the mid to long term, and that the board should establish, approve and disclose policies concerning the measures and organisational structures aimed at promoting constructive dialogue with shareholders.

13 The Code stipulates that as a part of establishing a framework for whistle-blowing, companies should establish a point of contact that is independent of the management, and that internal rules should be established to ensure the confidentiality of the information provider and prohibit any disadvantageous treatment.

## V SHAREHOLDERS

### i Shareholder rights and powers

***Voting rights***

In general, a company must treat its shareholders equally depending on the class and number of shares owned, and therefore each voting share has the same voting right. The Companies Act does, however, allow for the following exceptions: certain minority shareholders' rights, such as rights to propose an agenda for a shareholders' meeting, to inspect accounting books and to apply to a court for dissolution of the company; and different treatment for each shareholder in closed companies in terms of rights to dividends or distribution of residual assets, or voting rights at shareholders' meetings pursuant to the articles.

In a company with a board of directors, matters provided for in the company's articles and the Companies Act may be resolved at a shareholders' meeting. In the sense that each director must observe resolutions passed at shareholders' meetings, shareholders have an influence on the board.

Under the Companies Act, shareholders' approval is required for certain matters, including the following:

*a* amending the articles;
*b* mergers, corporate demergers, statutory share exchanges, statutory share transfers, assignment of business and reduction of stated capital;
*c* election or dismissal of directors and corporate auditors; and
*d* decisions regarding dividends of surplus (if a company has an accounting auditor and a board of corporate auditors or committees, however, and the term of office of its directors is no more than one year, the authority to determine the distribution of dividends of surplus can be delegated to the board by the articles).

***Rights of dissenting shareholders***

Shareholders who object to the proposed agenda specifically listed under the Companies Act, such as certain amendments to the articles and certain mergers and acquisitions, may demand that the company purchase their shares at a fair price. This price will be determined through negotiation between the parties (i.e., the company and the dissenting shareholder) or by court decision. If a demand is made and the parties are able to come to an agreement on the share price, the company must make the payment to the dissenting shareholder within 60 days of the effective date of the transaction contemplated in the proposed agenda to which the dissenting shareholder objected. If the parties are unable to reach an agreement with regards to the share price within 30 days of the effective date, either the dissenting shareholder or the company may file a petition to a court for a determination of a fair price within 30 days of the expiration of that initial 30-day period.

In the *Tecmo* case,[14] the Supreme Court presented a framework for determining a fair price under appraisal proceedings in cases where a joint share transfer (where two or more companies form a new holding company under the Companies Act) creates synergies. In this decision, the court found that:

14 Supreme Court, 29 February 2012.

*a* a fair price should, in general, be the value that the share should have had on the date on which the shareholder made a demand to the company for the repurchase of the share, on the assumption that the share transfer ratio designated in the share transfer plan is fair; and

*b* if a share transfer comes into effect through procedures that are generally recognised as fair, the share transfer ratio should be seen as fair unless special circumstances existed that hindered the shareholders' ability to make reasonable decisions in the shareholders' meeting.

## ii Shareholders' duties and responsibilities

### *Major shareholders' duties and practice*

Under the Companies Act, shareholders do not owe duties to the company other than paying the required share capital contribution for the shares to which they have subscribed. However, under the SLRs, if a listed company conducts certain transactions with its controlling shareholder, such as issuing shares or conducting mergers or business alliances, the company must obtain an opinion from a third party who is independent from its controlling shareholder that the transaction would not undermine the interests of minority shareholders of the company.

There are no specific duties of controlling shareholders to the company or other minority shareholders under the Companies Act. In an extreme case where a controlling shareholder abuses the company or other minority shareholders (e.g., a transaction with the company involving extremely unfair consideration or a squeeze-out of minority shareholders at an extremely low price), it may be liable for the abusive acts under the Civil Code or other laws, although there are no clear-cut standards for such cases.

## iii Shareholder activism

### *Derivative actions*

Under the Companies Act, a shareholder can demand that the company file an action to pursue, inter alia, directors or corporate auditors for their liabilities to the company if the shareholder has held shares of the company for the preceding six consecutive months or more. If the company does not file an action within 60 days of receipt of the demand from the relevant shareholder, the shareholder can file an action on behalf of the company.

Further, multiple derivative actions are allowed, subject to certain conditions, where, inter alia, a director or corporate auditor of a company might be sued by a shareholder of the company's ultimate wholly owning parent company[15] as long as, inter alia, the shareholder owns 1 per cent or more of the total voting rights or outstanding shares of the ultimate parent company, and the book value of the shares of the company constitutes more than 20 per cent of the total assets of the ultimate parent company as of the date of occurrence of the underlying events that gave rise to relevant obligations of the director or corporate auditor.

15 The company that directly or indirectly owns 100 per cent of the shares of the 'subsidiary' company, but that is itself not a wholly owned subsidiary of any other company.

***Proxy battles***

The FIEL stipulates the rules for proxy fights in listed companies. Under the FIEL, a shareholder or the company that solicits a proxy must provide the other shareholders with a certain set of documents (including a proxy and reference materials that set forth the agenda). It is generally considered to be difficult for a shareholder to embark on and succeed in such a proxy fight, mainly because the shareholder does not know the agenda of the shareholders' meeting until the convocation notice is sent by the company. In the past, because the Companies Act could be interpreted as allowing companies to refuse to provide the names, addresses and other information of other shareholders to a shareholder who wishes to solicit the proxy if the bidder is or works for a competitor of the company, the bidder could encounter even more difficulties. However, under the current Companies Act, even if the bidder is a competitor of the company, the company may not refuse to provide the information about other shareholders for that reason. In this sense, one of the hurdles to a shareholder embarking on a proxy fight would be alleviated.

### iv Takeover defences

As described above, the typical anti-takeover measure used by listed companies in Japan is a precaution-type anti-takeover measure. However, since the *Bull-Dog Sauce* case in August 2007, we have seen fewer attempts at hostile acquisition. In addition, the tender offer regulations under the FIEL were amended so that an offeror must now disclose more information prior to a tender offer and a target company has the right to issue a questionnaire to the offeror. In consequence, the number of listed companies that adopt anti-takeover measures has slightly decreased for 11 consecutive years.

### v Contact with shareholders

Under the Companies Act, directors, corporate auditors and executive officers must sufficiently explain the specific issues related to the agenda of the shareholders' meeting if an enquiry is made by a shareholder. In addition, to improve investor relations, Q&A sessions during shareholders' meetings are now actively encouraged in Japan. Furthermore, Japanese listed companies often hold informal meetings with investors about financial statements and related issues.

## VI OUTLOOK

The Reform Companies Act enacted in May 2015 has improved corporate governance (e.g., the comply or explain rule for the appointment of outside directors), and regulates the relationship between parent companies and their subsidiaries (e.g., clarifying the liabilities and rights of parent companies with respect to their subsidiaries (including derivative actions by shareholders of a parent company against the directors of its subsidiary)). In addition, the TSE formulated the Code in June 2015, which was revised in June 2018. The Code has established fundamental principles for effective corporate governance, including a structure for transparent, fair, timely and decisive decision-making by companies, which pays due attention to the needs and perspectives of shareholders and also customers, employees and local communities. Further, the Reform Cabinet Office Ordinance on the Disclosure of Corporate Affairs, etc. enacted in January 2019 has improved the level of disclosure regarding the corporate governance of the listed companies including the remuneration of such companies' directors.

Furthermore, the Reform Companies Act, which passed the Diet in December 2019, but has not yet been put in force, has further improved the corporate governance (e.g., requiring a large public company that is required under the FIEL to file a securities report: (1) to have one or more outside director; and (2) to establish company's policies for determination of the remuneration for each director). Corporate governance will continue to be a hot issue in Japan.

**Appendix 1**

# ABOUT THE AUTHORS

**MITSUHIRO HARADA**

*Nishimura & Asahi*

Mitsuhiro Harada has been a partner in the M&A and corporate group at Nishimura & Asahi since 2010 and was previously seconded to the US international law firm Sullivan & Cromwell LLP in New York for one year. Mr Harada has represented both Japanese and non-Japanese buyers or sellers in numerous cross-border commercial transactions in various industries, including stock and asset acquisitions, private equity and venture capital investments and strategic alliances. Mr Harada also has been involved in acquisitions and joint ventures in and outside Japan, especially in the South East Asian countries.

Mr Harada graduated from the University of Tokyo (LLB) in 1999 and gained his LLM from New York University School of Law in 2006. He was admitted to the Japanese Bar in 2000 and the New York Bar in 2007.

**TATSUYA NAKAYAMA**

*Nishimura & Asahi*

Tatsuya Nakayama has been a partner in the M&A and corporate group at Nishimura & Asahi since 2017 and was previously seconded to the US international law firm Weil, Gotshal & Manges LLP, in New York for one year. Mr Nakayama's practice covers a broad range of legal issues mainly related to corporate, securities and exchange, insurance, antitrust, intellectual property and tax law, and he has handled various domestic and cross-border M&A transactions including mergers, tender offers and incorporation of joint ventures, equity finance and strategic alliances, while also providing advice and legal support in commercial litigation.

Mr Nakayama obtained his LLB from the University of Tokyo in 2004, and his LLM degree and the certificate of merit award in mergers and acquisitions from the University of Michigan Law School in 2012. Mr Nakayama was admitted to the Japanese Bar in 2005 and the New York Bar in 2013.

**YOHEI OMATA**

*Nishimura & Asahi*

Yohei Omata has been an attorney-at-law in the M&A and corporate group at Nishimura & Asahi since 2012. Mr Omata's practice covers a broad range of legal issues mainly related to corporate, securities and exchange, antitrust, intellectual property and labor law, and he has handled various M&A transactions including mergers, tender offers and incorporation of joint ventures, while also providing advice and legal support in commercial litigation.

Mr Omata graduated from the University of Tokyo (B.A.) in 2009 and obtained his JD from the University of Tokyo, School of Law in 2011. He was admitted to the Japanese Bar in 2012.

**NISHIMURA & ASAHI**

Otemon Tower
1-1-2 Otemachi, Chiyoda-ku
Tokyo 100-8124
Japan
Tel: +81 3 6250 6200
Fax: +81 3 6250 7200
m_harada@jurists.co.jp
t2_nakayama@jurists.co.jp
y_omata@jurists.co.jp
info@jurists.co.jp
www.jurists.co.jp/en

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