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PROTECTING THE RIGHTS OF MINORITY SHAREHOLDERS IN PRIVATELY-OWNED JAPANESE COMPANIES

Taking a minority ownership position in a company is common practice in Japan in connection with mergers and acquisitions, joint ventures and venture capital investments. However, by owning less than a controlling interest of a company's outstanding shares, minority shareholders are normally unable to appoint persons to a company's board or influence actions submitted to the company's shareholders for approval. This inherent vulnerable position exposes minority shareholders to potential abuses by a majority shareholder who may direct the company's business affairs without regard to the concerns of the minority shareholders. Sophisticated investors are still willing to take minority equity ownership positions for a variety of reasons, including to (i) gain an initial foothold in a company to determine whether a subsequent full takeover is desirable, (ii) obtain access to new technologies, markets, or projects in exchange for a "token" capital infusion, or (iii) allow the existing owners to utilize their knowledge to operate the business while the minority shareholders provide expertise or capital in a cost efficient manner. Nonetheless, minority shareholders are typically not blind to the potential risks of abuse and unscrupulous control that a majority shareholder may exert despite the perceived benefits from the investment, and rightfully often request corporate governance rights to protect their investment.

Minority shareholders frequently seek assurances with respect to appointing board members and influencing the outcome of certain corporate actions (*i.e.*, veto rights). However, a wily majority shareholder can circumvent rights agreed for the benefit of minority shareholders, unless comprehensive safeguard measures are utilized. With proper planning and the implementation of certain techniques, minority shareholders can effectively preserve their agreed upon corporate governance rights and guard against oppressive measures adopted by a majority shareholder. This edition of the *Corporate Counselor* provides a roadmap for how minority shareholders can effectively implement and preserve negotiated corporate governance rights to protect their investments in privately-owned Japanese companies. This newsletter first addresses the basic protections afforded to minority shareholders as a matter of Japanese law, and follows with a discussion of more robust corporate governance provisions minority shareholders often seek and the best practices to uphold such provisions, and concludes with a suggested approach that minority shareholders may wish to adopt to uphold the enforcement of other key investment terms.

Basic Protections Available to Minority Shareholders under Japanese Corporate Law

There is no Japanese judicial precedent holding that a majority shareholder owes a fiduciary duty to other shareholders. Accordingly, there are two principal avenues of protection under Japanese law that a minority shareholder in a privately-owned company may use to counter abusive actions taken by a majority shareholder (though neither provide sufficient safeguards):

Statutory Rights. Japanese corporate law contains built-in rights to protect the basic interests of shareholders in a privately-owned Japanese company. For example, all shareholders are entitled to receive dividends unless restricted by the company's articles of incorporation, shareholders who own 3% or more of the company's voting rights can demand that the company convene an extraordinary shareholders' meeting and can inspect and copy the books and records of the company for legitimate purposes, and shareholders owning one-third or more of the company's voting rights can block various M&A transactions or amendments to the company's articles of incorporation. While these and other provisions of Japanese corporate law can be helpful to minority shareholders to prevent extreme self-dealing by a majority shareholder, reliance solely on the law is not helpful because it provides minority shareholders with only basic rights to counter extreme actions and not a tool to regularly monitor and protect an investor's equity.

Fiduciary Duties of Directors. Among other duties, directors owe a duty of care to the company under Japanese law (*i.e.*, directors must manage the

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company's business with the care of a good manager). A director's satisfaction of the duty of care of a good manager is usually evaluated under what is commonly termed the "business judgment rule." The Supreme Court of Japan held in 2010 that courts should not second-guess the business decisions made by directors and hold them liable if, in light of the standard of ordinary management in the same position, no material unreasonableness exists in the substance of the decision or the process in which the decision was made.

Accordingly, a minority shareholder would most likely come away empty-handed if it makes a claim that it was unfairly prejudiced by the actions of the board in a decision relating to the day-to-day operations of the company (such as the approval of a capital expenditure plan or the entry into a material contract against the wishes of the minority shareholder) since the director's duty of care is normally to the corporation itself and not the special interests of a few shareholders. A minority shareholder, therefore, would need to demonstrate how its special interests are actually in the best interests of the company as a whole, which could be a Herculean task.

Common Minority Shareholder Protections

Without assured corporate governance protections under Japanese law, minority shareholders often seek, at a minimum, board appointment and veto rights to protect their investment.

Board Appointment Rights. A minority shareholder may desire to have one or more designees sit on the company's board for a variety of reasons, such as to have access to key information about the business and operations of the company (which is often far superior to the access granted to a shareholder, subject to certain information sharing restrictions). Furthermore, having a representative on the board could enable the minority shareholder to influence the outcome of corporate decisions of the company, especially if a super-majority or the unanimous approval of all directors is required (as discussed below with respect to veto rights).

Under Japanese corporate law directors are normally appointed by a majority of the votes cast at a duly convened shareholders' meeting. While a company may opt in its articles of incorporation to adopt cumulative voting for the appointment of directors, such election is rare in Japan.

Veto Rights. While board appointment rights are beneficial, a minority shareholder is ordinarily not able to impact key business decisions of the company because it owns few shares and the board is dominated by the designees of the majority shareholder. With the grant of veto rights, the board and other shareholders of the company are not permitted to take specified actions without the affirmative approval of the minority shareholder. A veto right over key corporate events, therefore, can provide significant assurances to a minority shareholder that it will be able to protect its investment and shape the business operations of the company.

Appendix A lists illustrative veto items that a minority shareholder may seek over a Japanese privately-owned company. Ultimate agreement with the majority shareholder normally depends on the minority shareholder's ownership level in the company, the amount of its investment, its long-term interest in ultimately acquiring the company, and its non-financial contributions to the company. Appendix A differentiates the corporate governance level at which the veto matter is decided so a minority shareholder can properly layer its veto protective powers.

If a minority shareholder exercises its veto rights and blocks the company from undertaking a particular action and consequently the company suffers a loss, the minority shareholder ordinarily will not be held responsibility for such losses under Japanese law (absent exigent circumstances). Therefore, since veto rights can stall the company's business operations and allow the minority shareholder to act with impunity, the majority shareholder likely will request that appropriate deadlock procedures be agreed to prevent the company's business operations from deteriorating if a key matter cannot be timely resolved (*e.g.*, the ability for the majority shareholder to put/sell its shares to the minority shareholder or call/purchase the shares of the minority shareholder).

Methods to Implement and Preserve Minority Shareholder Protective Provisions

Entering into an agreement among shareholders is the simplest way to implement minority shareholder protective provisions. However, including minority shareholder protective provisions in the company's articles of incorporation through either higher approval thresholds or a classified share structure is the most secure way to preserve minority shareholder rights.

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An overview of each approach and its pros and cons is discussed below:

Contractual Arrangements. Providing for minority shareholder board representation and veto rights in a shareholders or joint venture agreement is common in Japan for a privately-owned company.

Board appointment rights. Shareholders can contractually agree under Japanese law on how many persons each shareholder will be entitled to nominate to serve as directors of the company, with the parties agreeing in advance to vote their shares in favor of the other party's nominees (subject to minimum suitability standards for the persons nominated). A minority shareholder who has secured the right to appoint a director also should take steps to prevent the subsequent removal of its director nominee from office. Legal counsel should be consulted to determine how to best address an inadvertent removal. In addition, to guard against the possibility that the board takes action while the minority shareholder's director nominee is not serving on the board (*e.g.*, due to death or resignation), the shareholders should agree that the board is prohibited for a reasonable period of time from taking action until the vacancy is filled. Unlike other jurisdictions, under Japanese law a board is not entitled itself to fill vacancies and shareholder action is required.

Veto rights. The easiest way to establish a minority shareholder veto right is for the shareholders to set a unanimous vote requirement at the board and shareholder level of the company (as illustrated in Appendix A). In other words, the proposed action could not be adopted by the company unless the minority shareholder and/or its designee on the company's board approves.

Veto rights are of limited value if meetings can be held without the minority shareholder or its director nominee in attendance (otherwise, the majority shareholder could control the outcome), so the minority shareholder should insist on quorum levels that ensure the minority shareholder is represented at board and shareholder meetings, and such quorum provisions should appear in the company's articles of incorporation to the extent permissible. On the other hand, a majority shareholder will have legitimate concerns that a minority shareholder could prevent the holding of board and shareholder meetings by intentionally not attending (resulting in the failure to achieve a quorum), so the shareholders should agree on how meetings that will not resolve a veto matter can proceed even if the minority shareholder fails to participate.

Pitfalls to contractual arrangements and possible solutions. Although shareholder, joint venture and other equity agreements can be promptly implemented, such arrangements alone may not ultimately serve the best interests of a minority shareholder for the following reasons:

- No automatic transfer of rights. The rights agreed in a contract will not automatically follow a transfer of shares by the minority shareholder. Therefore, a minority shareholder may have difficulty selling its interest in the company to a new shareholder because the transferee would not automatically step into the shoes of the minority shareholder under the arrangement agreed with the majority shareholder (leaving the new shareholder exposed to potential abuse from the existing majority shareholder), unless the shareholders otherwise agree.

- Board stacking. Super-majority board veto rights can be thwarted if a majority shareholder can stack the board (*i.e.*, appoint additional directors to dilute the representation of the minority shareholder's nominees below the agreed super-majority threshold). To counter board stacking a minority shareholder should insist that the articles of incorporation include a provision specifying the maximum number of directors, which would serve as an effective block so long as the minority shareholder owns a sufficient number of shares to prevent amendments to the company's articles of incorporation without its consent (currently, one-third or more of the company's voting rights).

- Potential enforcement difficulties. If the majority shareholder breaches its obligations under a contract to vote its shares to approve the appointment of the minority shareholder's board nominees or to adopt a matter only if the minority shareholder approves, it could be difficult for the minority shareholder to demonstrate adequate monetary damages, thereby leaving the minority shareholder with a right that does not have an effective monetary remedy for breaches. On the other hand, the Tokyo High Court held in 2020 in *dicta* that as long as all of a company's shareholders are parties to a shareholders agreement (or similar arrangement) and the veto rights scheme under the agreement is unequivocal, then an aggrieved minority shareholder is entitled to enjoin the majority shareholder's breaching action or bring a claim to invalidate the applicable shareholders meeting.

However, obtaining a temporary restraining order takes time, pending which the company's board will be lawfully constituted, so the company's board and shareholders could take actions contrary to the desires of the minority shareholder that cannot be unwound (which was the ostensible reason for granting the minority shareholder the protective provision in the first place).

To overcome (at least to-some-extent) the precarious contract enforcement rights of a minority shareholder if the board appointment or veto provisions are not honored, the shareholders could agree that the non-defaulting shareholder (the minority shareholder) could put/sell its shares or call/purchase the shares of the defaulting majority shareholder at a favorable price. However, this may not be ideal for the minority shareholder if it does not want to exit the investment at such time (in the case of the put) or it does not have adequate financial resources to acquire additional shares or the desire to control the company (in the case of the call), let alone if there are Japanese foreign direct investment regulations that could prevent the minority shareholder from acquiring additional shares due to a government consent requirement. Alternatively, a breach could trigger a cross-default under one or more operative agreements to which the minority shareholder is providing a good or service to the company. Depending on the materiality of the other operative agreement (*e.g.*, if the minority shareholder is providing key trademarks and technology to the company under a licensing agreement), the threat of terminating a material contract could persuade a majority shareholder to comply with its obligations.

Higher Approval Thresholds in Articles of Incorporation. Japanese corporate law allows a company to increase (but not decrease) in its articles of incorporation the approval threshold for matters that require board or shareholder consent under Japanese law. However, providing a unanimous consent requirement for board and shareholder decisions can have a whipsaw effect on an existing minority shareholder when new shareholders are introduced because a unanimous approval requirement would allow new shareholders similar blocking rights. Furthermore, relying on a super-majority shareholder consent requirement is not advisable when a minority shareholder owns less than one-third of the company's voting rights because the majority shareholder could cause additional shares to be issued to sufficiently dilute the ownership position of the minority shareholder below the agreed consent percentage threshold.

Classified Shares. The most secure way to assure that a minority shareholder will have representation on the company's board and to enforce veto rights is to establish a classified share scheme in the company's articles of incorporation. Under this method, designated classes of shares are created with each class given the right to elect a specified number of directors and approve specified matters.

A classified share structure addresses the potential pitfalls when rights are agreed in a contractual arrangement and offers a variety of benefits, such as:

- *Certainty*. Providing board appointment and veto rights through a classified share structure is extremely effective because actions taken by a majority shareholder in contravention of such rights would violate the company's articles of incorporation and would be void *ab initio*. A minority shareholder would not need to make a breach of contract claim and rely on damages flowing therefrom, or seek to enjoin the majority shareholder's action or bring a claim to invalidate the applicable board or shareholders meeting. The minority shareholder, therefore, would be able to swiftly enforce its board appointment and veto rights at a relatively low cost.

- *Versatility*. If a company has three shareholders and each will have director appointment and veto rights, then the company could issue three classes of shares. One class would be issued to each shareholder, and each class would be entitled to elect one director and enjoy specified veto rights. The classes could be similar in all other respects, or they could have different dividend or liquidation preferences.

- *Counters Board Stacking.* A majority shareholder would not be able to unilaterally increase the size of the company's board under a classified share structure because each class is entitled to appoint a fixed number of directors pursuant to the company's articles of incorporation.

- *Dilution Protection*. While unanimity and super-majority approval requirements are easy to manage when additional shareholders are not expected, if the company issues new shares or provides future shareholders with board appointment rights, then an existing minority shareholder could be whipsawed as explained above. The foregoing would not occur if the existing minority shareholder receives a classified share because the rights would be fixed with the shares and not based on an approval threshold.

- *Survival.* The majority shareholder and its director nominees would not be able to orchestrate an amendment to the company's articles of incorporation to eliminate or diminish the rights granted to the classified share without the consent of the holder of the classified share. Accordingly, the rights of the minority shareholder would survive until the company's articles of incorporation have been duly amended, and the rights afforded to the classified share would pass to a new holder of the classified share without requiring any contractual amendments or the receipt of the majority shareholder's consent (absent contractual share transfer restrictions). The foregoing survival assurances and the relative ease of transferring rights agreed with a minority shareholder to a third party may be the precise reason why a majority shareholder would disfavor a classified share scheme.

Despite its benefits, a classified share structure with board appointment and veto rights is uncommon in Japan. There is no clear explanation for its lack of traction in Japan deal-making. A possible reason for its disfavor is that the terms and provisions of the classified share scheme will be replicated in the company's commercial registry, which is publicly available in Japan (unlike a company's articles of incorporation, which is a private document), so the shareholders may prefer that third parties are not able to ascertain the corporate governance dynamics of the company. Furthermore, a majority shareholder may contend that the rights it agreed with the minority shareholder are unique to that minority shareholder and should not be automatically assumed by the purchaser of the classified share (even if there is a right of first refusal mechanism agreed between the majority and minority shareholders). On a more fundamental level, implementing a classified share scheme became practical in Japan only since 2006, so the structure is relatively new and its adoption may cause trepidation with traditional deal-makers. Japanese companies are also famous (and often praised) for placing upfront trust in counter-parties, so there could be a perception that implementing extra steps to facilitate the enforcement of an agreement is unnecessary and detracts from important mutual trust. Finally, while an overseas buyer may be accustomed to a classified share structure in its home jurisdiction, it may defer to local market practices when making a minority investment given its perceived lower bargaining power (absent exigent circumstances), which would continue the prevalence of a single share class investment scheme even in the cross-border context.

Conclusion

A minority shareholder will often seek various commercial terms apart from board appoint and veto rights in connection with an equity investment. For example, a minority shareholder may negotiate the company's business scope, dividend policy, procedures for holding shareholder meetings, restrictive covenants, share repurchase obligations by the company, liquidation preferences, and share transfer restrictions (including pre-emption rights).

A minority shareholder may mistakenly believe that a contract is the first and only instrument to document other key investment terms. While memorializing other key investment terms in a contract is beneficial and common practice given Japan's approach that parties are generally free to contract, similar to board appointment and veto rights, a minority shareholder should seek to replicate key investment terms into the company's articles of incorporation to the maximum extent legally permissible and to the extent practicable in light of the expectations and perception of the counterparty, so breaches are invalidated swiftly by operation of law and the minority shareholder does not bear the burden of proving damages. As a company's articles of incorporation are not publicly available in Japan (except for those portions that are repeated in the company's commercial registry), memorializing rights in the articles of incorporation will not allow third parties to access sensitive investment terms. On the other hand, if the articles of incorporation contain a term that conflicts with a contractually agreed provision, then the minority shareholder may not be able to pursue a breach of contact claim because the terms of a company's articles of incorporation are normally superior in right to those in a contract.

Replicating other key investment terms in a company's articles of incorporation is often not considered by deal-makers in Japan as this placement has not been common practice. Legal counsel should be retained to advise on the scope and optimal placement of the rights afforded to a minority shareholder taking a holistic view on the equity investment by the minority shareholder.

Appendix A

Veto Rights[1]

Action	Board Approval Required	Shareholder Approval Required
Amending the company's articles of incorporation	✓	✓
Amending material internal policies and rules of the company's board of directors	✓	✕
Entering into any merger, consolidation, corporate split, share exchange, share transfer or other types of corporate reorganizations or restructurings involving the company	✓	✓ (*except for short-form mergers and alike*)
Entering into a capital or business alliance involving the company	✓	✕ (*except where the company issues securities to an alliance partner*)
Purchasing or acquiring in a single or a series of transactions by the company all or substantially all of the assets or any shares of capital stock of another entity in excess of [*an amount that is material to the company's business*]	✓	in the case of business acquisitions (*except for a short-form business acquisition*) ✓ in the case of share acquisitions ✕
Selling, leasing or otherwise disposing of key assets of the company (that do not constitute all or a material portion of the company's assets or properties)	✓	✕
Selling, leasing or otherwise disposing of all or a material portion of the company's assets or properties in a single or a series of transactions	✓	✓
Issuing any security authorized under the company's articles of incorporation	✓	✓

[1] This table is applicable only to a privately-held company that has a board of directors corporate governance scheme with standard articles of incorporation. As the allocation of authority varies depending on the corporate governance scheme selected, legal counsel should be retained to ensure the effectiveness of desired veto rights in relation to the subject company's corporate governance scheme.

If a transaction does not satisfy [*an amount that is material to the company's business*], then no board or shareholder approval would be required under Japanese corporate law, however, such approval could be required pursuant to a shareholders' agreement.

Action	Board Approval Required	Shareholder Approval Required
Creating a new class of company securities, reclassifying existing company securities (including any options, warrants or other rights to purchase any voting security), or changing the rights and preferences of existing company securities	✓	✓ *(except for share splits)*
Redeeming or repurchasing company securities	✓	✓ *(only in the case of share repurchases)*
Approving affiliate transactions	✓	✕
Declaring company dividends or other distributions of any kind to shareholders	✕	✓
Approving the company's annual business plan	✓	✕
Adopting the company's annual capital expenses and operating budgets or agreeing to any amendment in excess of [*an amount that is material to the company's business*]	✓	✕
Approving the company's annual financial statements	✓	✓
Changing the company's amount of stated capital or capital reserves	✓	✓
Changing the company's financial, tax or accounting year, and establishing or changing its accounting methods and procedures (and any material changes thereto)	✓	✓ *(only in the case of changing the fiscal year)*
Engaging in any material new line of business by the company	✓	✕
Entering into, assigning, extending or materially modifying any of the company's agreements that have a value in excess of [*an amount that is material to the company's business*]	✓	✕
Incurring, assuming or guaranteeing indebtedness by the company in excess of [*an amount that is material to the company's business*], or repaying any indebtedness prior to its stated maturity in excess of [*an amount that is material to the company's business*]	✓	✕
Extending indebtedness by the company in excess of [*an amount that is material to the company's business*]	✓	✕
Creating or permitting to exist any lien or encumbrance upon any of the company's properties or assets in excess of [*an amount that is material to the company's business*]	✓	✕

Action	Board Approval Required	Shareholder Approval Required
Determining the salaries and other compensation and benefits for the company’s senior personnel	✓	✓
Dismissing, materially changing the job responsibilities, or placing on secondment any of the company’s senior personnel	✓	✕
Forming a company subsidiary	✓	✕
Initiating, terminating or settling any litigation or arbitration involving the company where the potential damage claim is in excess of [*an amount that is material to the company’s business*], or where the counter-party is a governmental agency	✓	✕
Filing a bankruptcy petition, initiating any type of dissolution or reorganization event (whether voluntary or not), or acquiescing in the appointment by a court of a trustee, receiver or liquidator of all or any substantial part of the company’s properties or assets	✓	in the case of dissolutions ✓ other than a dissolution ✕