Chapter 12

JAPAN

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I OVERVIEW OF GOVERNANCE REGIME

Sources of law and enforcement

Companies in Japan are generally regulated by the Companies Act (Act No. 86 of 26 July 2005) ('the Companies Act'). Further, listed companies in Japan are also regulated by the Financial Instruments and Exchange Law (Act No. 25 of 1948) ('the FIEL') and the Securities Listing Regulations published by each securities exchange in Japan ('the SLR'). As the securities exchanges in Japan, in publishing the SLR, generally follow the SLR published by the Tokyo Stock Exchange ('the TSE'), which is the largest securities exchange in Japan, the information we provide hereafter focuses on the SLR published by the TSE, and references to 'SLR' are to the SLR published by the TSE.

In the event a company violates the Companies Act, depending on the specific provision that is violated, shareholders or creditors of the 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. The SLR is enforced by the specific securities exchange that published the applicable SLR. Violations of the SLR generally lead to the securities exchange requiring the company to submit an improvement plan. In extreme cases, securities exchanges may even delist the company.

Nature and recent development of 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 SLR on 30 December 2009,

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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 such a person was appointed as an independent director or corporate auditor must also be provided in the company's corporate governance reports under the SLR.

In Japan, roughly speaking, there are two types of governance systems, one being a company with a corporate auditor and the other being a company with committees. 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 committees perform auditing and monitoring functions:

a a nominating committee that decides on the agenda of nominating or dismissing directors at shareholders' meetings;

b an audit committee that audits the execution of duties of executive officers and directors; and

c 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 rather to monitor the execution of the executive officers' duties 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. A company with a corporate auditor may, however, also voluntarily establish an internal committee system similar to a company with committees.

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, however, shareholders of a company without a board have broader decision-making authority, such as the ability to approve certain competitive activities by or conflicts of interest of directors.

A company with a board 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. 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, a company with a board generally must have a corporate auditor. In a company with a corporate auditor, the board has decision-making authority over the management of the company, and representative directors and other authorised directors are responsible for executing such decisions. The corporate auditor generally audits the execution of duties by directors, with a view to compliance with laws.

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 such authority to executive officers, and representative executive officers are responsible for executing such 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 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 by and conflicts of interest of directors, and appoint committee members. The audit committee audits the execution of duties by directors with a view to not only compliance with laws, but also the appropriate performance of their duties.

Delegation of responsibilities

In a company with a corporate auditor and a board (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 committee, audit committee and compensation committee each has its 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 the following matters:

a basic management policy;
b matters necessary for the execution of the audit committee's duties;
c if there are two or more executive officers, matters relating to the interrelationship between executive officers; and
d development of internal control systems.

A board 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 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 Japan, normally the board appoints the CEO or its equivalent from among its representative directors (in the case of a company with a corporate auditor and a board) 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. It is worth noting that in Japan a director of a company who is a retired CEO of that company may have the title of '*kaicho*' as an honorary position, which can sometimes be translated as 'chair'.

Remuneration of directors

In a company with a corporate auditor and a board, 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 such aggregate amount.

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

An open company (a company, typically listed, whose articles do not require the company's approval for any transfer of the company's shares, whether it is a company with a corporate auditor 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. In addition, a listed company must disclose the following information in its securities report: the amount of remuneration and a breakdown by type of payment (e.g., salary, bonus, stock option 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 1,897 companies that submitted securities reports in June 2011, the number of directors, corporate auditors and executive officers that received ¥100 million or more as remuneration for the fiscal year ending March 2011 was 273); and an explanation of the company's policies for remuneration of directors, corporate auditors and executive officers and how remuneration is determined if such policies are put in place (e.g., as set forth above, 'remuneration for a director consists of fixed compensation and a bonus, with the fixed portion determined based on the position of the individual and the bonus determined based on the performance of the company and the individual').

Board and company practice in takeovers

Listed companies in Japan generally use a 'precaution type anti-takeover measure', whereby a company announces a takeover process rule but does not issue any securities at first. Although there are many variations to this measure, generally the company announces in advance a certain takeover process rule to the effect that a takeover bidder must provide sufficient information to the board 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 such bid (but the analysis by the board must be completed within a certain period, such as 60 days). If such 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 is damaged or that maximising the value is prohibited (including if the bidder does not comply with such procedures), usually based on analysis by a third-party committee, certain anti-takeover measures will 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 (Supreme Court, 7 August 2007) 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 of 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, such 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 such issuance was valid.

Since this case, we have seen fewer attempts at hostile acquisition. 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 slightly decreased for three consecutive years (from 570 companies at the end of July 2008 to 521 companies at the end of July 2011).

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, the board generally nominates directors with two-year terms of office (maximum). On the other hand, in a company with committees, the nominating committee nominates directors with one-year terms of office (maximum).

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.

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, 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 of a prudent manager to the company. Under the 'business judgement rule' in Japan, 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 (i) the director made important and careless mistakes in the recognition of facts; or (ii) the process and content of the director's decision-making is particularly unreasonable or improper as determined by a management expert. Nevertheless, Japanese 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.

Recently, in the *Apamanshop* case, the 'business judgement rule' was affirmed by the Supreme Court of Japan. 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 in order to make such 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 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 served as executive directors, executive officers or employees (including managers) of the company or any of its subsidiaries. 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. On the other hand, in a company with a corporate auditor and a board, there are no such requirements concerning board composition.

The TSE requires listed companies to have one or more independent directors or corporate auditors (see Section I, *supra*). Therefore, it is considered that persons who work for a company's parent company or its business partner and consultants who receive significant fees from the company, etc., cannot be independent officers of the company.

Legal duties and best practice for directors

The legal duties of outside directors are generally the same as for 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 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 such roles as well, outside directors are expected to do so more effectively due to their objective position.

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

In a company with a corporate auditor and a board or a company with committees, if a director intends to carry out any transactions involving a conflict of interest, approval must be obtained at a board meeting, at which such 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.

iii Auditors

In a company with a corporate auditor and a board, the corporate auditor audits the execution of the directors' duties, including preparation of financial statements. 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, *supra*).

In addition, a 'large company' (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. Accounting auditors' 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.

III DISCLOSURE

Financial reporting and accountability

A representative director or representative executive officer will prepare a financial statement within three months after the end of each business year. A large company that is required to file a securities report under the FIEL (for example, a listed company or a company with at least 1,000 shareholders as of the end of any fiscal year within the last 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 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. A listed company is required to submit its securities report within three months after the end of its fiscal year under the FIEL.

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.

IV CORPORATE RESPONSIBILITY

Internal control

Boards of large companies must develop internal control systems that ensure that directors comply with laws and the 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.

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

Specific contents of the internal control systems may be decided at the discretion of the company. 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, etc.

The employer of a whistle-blower is prohibited from treating the whistle-blower in any disadvantageous manner, such as demoting or reducing his or her salary, if this is in response to the employee's whistle-blowing, under the Whistleblower Protection Act.

Corporate social responsibility to employees and wider society

In Japan, a company is required to hire a certain number of handicapped persons 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.

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, 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. The price will be determined through negotiation between the parties (i.e., the company and the dissenting shareholder) or by court decision. If such 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 the court for a determination of a fair price within 30 days of the expiration of that initial 30-day period.

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. It should be noted, however, that under the SLR, if a listed company conducts certain transactions with its controlling shareholder, such as issuing shares, mergers or business alliances, the company must obtain an opinion from a third party who is independent from its controlling shareholder that such a 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 such 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 directors, corporate auditors, etc., 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, the shareholder can file an action on behalf of the 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 to allow the company to refuse to provide the names, addresses and other information of other shareholders to the 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, a recent judicial precedent (i.e., the *Nihon Housing* case) shows that even if the bidder is a competitor of the company, if such bidder proves that the purpose of its request is to research on securing or exercising its rights, the company may not refuse to provide such information of other shareholders for that reason. In this sense, one of the hurdles to a shareholder embarking on a proxy fight may have been alleviated based on this recent case.

VI OUTLOOK

The Japanese government is currently holding discussions about amending the Companies Act and recently published a draft interim proposal for amending the Companies Act. The primary objective of the amended law is to improve corporate governance (e.g., compulsory appointment of outside directors), and to regulate the relationship between parent companies and their subsidiaries (e.g., clarify 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).

Recently, in the *Olympus* case, according to an investigation report dated 6 December 2011 that was prepared by a third party committee:

> *The loss disposition scheme is characterized by Olympus' selling the assets that incurred loss to the Funds etc., set up by Olympus itself, and subsequently, providing the finance needed to dispose of the loss under the cover of the company acquisitions. More specifically, there was the situation of providing financing to the Funds by acquiring the venture businesses owned by the Funds at the substantially higher price than their real value, and the situation of making the funds flow back by paying substantially high [sic] fees to a third party who acted as the intermediate in the acquisition.*

Thereafter, according to a news release issued on 18 January 2012 by Olympus in response to the investigation report, Olympus filed lawsuits in January 2012 against its current and past directors and corporate auditors seeking compensation for damages. Recent scandals in Japan, such as this case, have cast a critical light on Japan's corporate governance system, and have intensified discussions about making the appointment of outside directors mandatory and stipulating stricter requirements with respect to outside directors by amending the Companies Act, the SLR, or both.

Appendix 1

ABOUT THE AUTHORS

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Mr Tanigawa has been a partner in the M&A/corporate group at Nishimura & Asahi since 2008 and was previously seconded to the top-tier US international law firm, Debevoise & Plimpton, in New York for one year. Mr Tanigawa has represented Japanese and non-Japanese buyers and sellers in numerous cross-border commercial transactions in various industries, including stock and asset acquisitions, private equity and venture capital investments, joint ventures and strategic alliances. Mr Tanigawa writes and lectures widely on these and other topics.

Mr Tanigawa graduated from the University of Tokyo (LLB) in 1997 and gained his LLM from Cornell Law School in 2005. He was admitted to the Japanese Bar in 1999 and the New York Bar in 2006.

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Mr Moriyama is a senior associate in the M&A/corporate group at Nishimura & Asahi. He manages structured M&A transactions, legal due diligence, documentation and negotiations on agreements, and client relationships in various M&A deals primarily between domestic and overseas companies, in the fields of IT, pharmaceuticals and financial industries.

Mr Moriyama obtained his LLB degree from the University of Tokyo in 1999, his LLM degree from the University of Virginia in 2006 and his MBA from Northwestern University, Kellogg School of Management, in 2008. Mr Moriyama has been a member of the Japanese Bar since 2000 and the New York Bar since 2009.

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