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Doing Business in Japan



CHAPTER 7 Business Organization

*3-7 Doing Business in Japan § 7.02*

**§ 7.02 Company Law in General**

**[1] Company Law in General**

**[a] Sources of Company Law.** The primary source of company law presently in Japan is the new Company Code (Law No. 86, 2005), n1 which collects and reorganizes the substantive content of laws such as: the Commercial Code (Book II, *Kaisha* or "Company"); Limited Liability Company Code; Act Providing Exceptions to the Commercial Code for Large Stock Companies; Secured Bonds Trust Act; Company Rehabilitation Act; Commercial Registration Act; and the Corporate Bond and Debenture/Stock Act, etc. Transfer Act. n2 Ministerial ordinances issued pursuant to these laws (Regulations on the Implementation of the Company Code, etc.) are also considered sources of company law; customary law (so-called *kanshuho*) is another source of law (Commercial Code, Art. 1, Para. 2).

**[b] The Characterization of Companies as Juridical Persons.** The new Company Code stipulates that "a company (*kaisha*) is a juridical person (*hojin*)" (Company Code, Art. 3). Upon its recognition as a juridical person, a company may engage in business under its own name, possess legal rights, and bear legal obligations. However, the grant of these special rights to companies is predicated upon the condition that companies as juridical persons promote the interests of the society that recognizes them, and in the event that a company's activities instead are detrimental or contrary to the societal interests, the company's continued existence is subject to total or conditional termination (Company Code, Art. 824, Para. 1).

**[c] Limits on Capacity to Perform Juridical Acts.** Companies are juridical persons, as and such they have the legal capacity to possess rights and obligations, i.e., what is referred to as "rights capacity" (*kenri noryoku*) under Japanese law; however, this is not to say companies possess identical rights capacities as natural persons. The law, as well as the juridical nature of companies, creates some inherent rights capacity limitations, such that certain rights that require characteristics unique to natural persons, such as rights of succession, as well as other rights and obligations requiring animate physical existence, corporeality, social status, etc., cannot be possessed by juridical persons, including companies. In addition, there is some scholarly disagreement as to whether the purpose of a company's activities as prescribed in its *teikan*, or articles of incorporation and bylaws (Company Code, Art. 27, Item 1), necessarily operates as a limiting clause to invalidate company acts that are contrary or unrelated to the stated business purpose. As a practical matter, past judicial decisions indicate that courts recognize, as a general legal principle, that a company's express purpose may be understood as constituting a restrictive prescription regarding its ability to perform juridical acts that are unrelated or contrary to that purpose.

**[d] Various Types of Companies.** There are four types of companies that may be created under the new Company Code, n3 as set forth in Article 2, Item 1:

- Stock company (*kabushiki gaisha*): n4 the standing of the company's equity holders are determined by legal ownership held in the form of fractional, proportional units of equity, or stock shares (*kabushiki*); the shareholders of the stock (*kabu-nushi*) are responsible for the financial obligations of the company, but as to each shareholder, those obligations are limited to the extent of the subscription price paid for the stock owned by the shareholder. Thus, in the event the company is in debt, shareholders have no liability of any kind to the company's obligees or other obligees exceeding their own capital investment in the company.

- Partnership company (*gomei gaisha*): made up solely of equity holders called general partners, each of whom bear direct and unlimited liability borne jointly and severally by all of the partners (*mugen seki nin sha in*, "unlimited liability member") as to the company's obligees and other obligees, *see* Company Code, Art. 580. This type of company has fallen out of favor, and is now rarely created.

- Limited partnership company (*goshi gaisha*): a variation upon the partnership company that is structured to consist of both limited partners, whose responsibility for company liabilities is limited to their own investment in the company, and general partners with the same expansive direct liability as the general partners of a *gomei gaisha*. This type of company has fallen out of favor, and is now rarely created.

- Limited liability company (*godo gaisha*): a type of company that is organized to consist solely of equity holders, with a legal status much like that of limited liability partners of *goshi gaisha* (Company Code, Art. 576, Para. 4, Arts. 578 and 580) as against third parties, although within the company there may be cooperative, general partnership-type rules governing the relationship between company members (Company Code, Art. 585, Para. 1, Arts. 590 and 637). This type of company was created under Japanese company law in significant part by referring to American law regarding LLC's.

**[e] Classification of Companies Under the Company Code.** The four types of companies set forth in [d] can be essentially divided conceptually into stock (*kabushiki*) companies and so-called *mochibun* or non-stock companies; partnership companies, limited partnership companies and limited liability companies are included in the *mochibun* company category (Company Code, Art. 575, Para. 1).

There are other legal distinctions that apply only to stock companies, such as the designation of "large company" (*daigaisha*), which is a company with either a capital amount of yen 500 million or greater, or outstanding liabilities of yen 20 billion or greater (Company Code, Art. 2, Item 6). There is also the distinction made between public companies (*kokai kaisha*) and companies that are not public companies (*hikokai kaisha*). Furthermore, because various models for organizing the governance of stock companies are available under the Company Code, it is possible to characterize companies based upon the system of corporate governance utilized, such as companies with a board of directors (*torishimariyaku kai secchi kaisha*), companies with accounting counselors (*kaikeisanyo secchi kaisha*), companies with auditors (*kansayaku secchi kaisha*), and companies with board committees (*i inkai secchi kaisha*), etc. n5

**[2] Stock Companies**

**[a] General Concepts.** Stock (*kabushiki*): company ownership is in the form of owning equity in the company divided into units (shares) that are generally proportionate and fractional. Stocks come in two types, par value stock (*gakumen kabushiki*) and no-par value stock (*mu-gakumen kabushiki*); at the present, all stock issued by stock companies is of the no-par value variety (2001 Amendments). Holders of company stock are referred to as shareholders or stockholders (*kabu-nushi*).

Limited liability (*yugen sekinin*) of shareholders: generally speaking, the legal liability of a shareholder to his company and to outside obligees and other obligees is limited to the price paid by the shareholder for the shares, and no obligations of any kind beyond that may be placed upon him (the principle of limited shareholder liability, Company Code, Art. 104).

Capital: from the standpoint of protecting its obligees, a company is required to fix an amount of certain asset holdings that represents its self-imposed minimum limit, make public disclosure of this amount, and at all times hold assets at least corresponding to this amount. This fixed amount of money is the company's capital. However, the minimum required capital is the same as that under Delaware law in the United States, and any sum greater than zero, even yen 1, satisfies this requirement, although it does cost approximately yen 350,000 to register a company and have its articles and bylaws notarized.

**[b] Formation of a Stock Company (Incorporation)**

**[i] The Two Methods of Incorporation.** There are two methods for setting up a stock company, incorporation by promotion (*hokki setsuritsu*) and incorporation by subscription (*boshu setsuritsu*). The former is a method by which the entirety of the initial stock issuance at the time of incorporation is made to the promoter or promoters (Company Code, Art. 25 Para. 1 Item 1), and the latter is a method by which the promoter is allotted only a portion of the initial stock issuance, and the remainder is offered by subscription to other investors at the time of incorporation (Company Code, Art. 25 Para. 1 at Item 2).

**[ii] The Incorporation Process in Detail.**

**[A] The Promoter. n6**

The promoter (*hokki nin*) is the person who signs, or ascribes his sign and seal, upon the articles of incorporation and bylaws (Company Code, Art. 27, Item 5). The promoter must be issued at least one share of stock when the company is incorporated. The law imposes no particular restrictions or conditions in regard to the qualifications of a promoter, and thus persons of restricted capacity, juridical persons, foreign persons, etc., may be promoters. Also, while a company's incorporation may be carried out by multiple promoters, one promoter is all that is necessary. The promoter, by engaging in the necessary acts of drawing up of articles and bylaws and issuing stock, can be thought of as the initial equity owner in the stock company, but also can be thought of as the executive and decision-making instrumentality acting on behalf of the stock company during the incorporation process.

**[B] Preparing the Articles of Incorporation and Bylaws.**

The articles of incorporation and bylaws of the stock company (collectively *teikan*) are the documents stipulating the basic terms, rules and regulations pertaining to the organization and management of the stock company (an electronic recording is also acceptable); the initial articles of incorporation and bylaws (*genshi teikan*) are drafted by the promoter, and if there are more than one promoter, the initial articles and bylaws reflects their collective resolution regarding the terms (Company Code, Art. 26). However, in the event of incorporation by subscription, it is possible to amend the articles and bylaws at the first general meeting of shareholders (Company Code, Art. 66, Art. 73, *Paras. 2-4).* The terms contained in the articles and bylaws are one of three types, as set forth below:

**[I] Mandatory term.** A mandatory term (*zettaiteki kisai jiko*) must be contained in the articles and bylaws, or else its omission renders the articles and bylaws void in their entirety. The terms that are mandatory under company law (business purpose, company name, address of principal office, etc.) are set forth in Article 27 of the Company Code.

**[II] Relative term.** In contrast to mandatory terms, omitting a relative term (*sotaiteki-kisai jiko*) does not affect the basic validity of the articles and bylaws, but such a term must be prescribed in the bylaws if they are to apply to the

company at all; i.e., relative terms not prescribed in the bylaws may not be established elsewhere as internal company regulations, etc. Terms designated as relative terms by law, such as those concerning in-kind contributions (*genbutsu shusshi*), asset investment (*zaisan hikiuke*), promoter compensation (*hokki-nin no hoshu*), etc., are set forth in Article 28 of the Company Code. Voluntary terms are also referred to as "nonstandard formation terms" (*hentai setsuritsu jiko*).

**[III] Optional term.** Any term that may be included in the articles and bylaws that does not belong to one of the above two categories is an optional term (*kisai jiko*). Omitting an optional term does not affect the validity of the articles and bylaws, and it is not necessary to put this type of term in the bylaws to make it a valid, enforceable rule for the company, which distinguishes it from a relative term, which may not be established unless it is in the bylaws. However, by stating an optional term in the bylaws its validity is formally strengthened, because it becomes necessary to amend the bylaws in order to modify or remove the term.

The time and date for convening stockholders' general meetings, the number of corporate directors, auditors, etc., are examples of commonly seen optional terms.

**[C] Incorporation by Promotion.** When incorporation is by promotion (*hokki setsuritsu*), all of the stock issued is distributed to the promoter or promoters. In exchange for receiving an allocation of the stock shares, each of the promoters must pay to an instrumentality designated by the promoters the entire price for the stock received (Company Code, Art. 34, Para. 2). Once the promoters have fulfilled their capital contributions, they must, promptly and without delay, select and appoint the initial director (or directors) of the stock company (Company Code, Art. 38, Para. 1).

Depending on the system of corporate governance adopted by the company upon its establishment, it may also be necessary to select and appoint initial accounting counselors, initial auditors, etc.

**[D] Incorporation by Subscription.** Where incorporation is by subscription (*boshu setsuritsu*), after the promoters have made their initial capital contributions, the promoters may, upon unanimous consent, also invite third parties to become company shareholders by subscribing to the initial issuance of stock (Company Code, Art. 57; Art. 59 Para. 2). There are no specific restrictions regarding how this subscription is conducted; for example, a subscription offer is valid whether it is offered publicly or privately.

If an investor applying to be a shareholder tenders an offer to purchase of all of the shares of stock made available in a particular subscription offer, the promoter may induce the other applicants to withdraw their subscription applications in order to accommodate the applicant offering to buy all the stock. However, once the promoter conducts this involuntary revocation of subscription applications, the subscriber agreeing to acquire the entire stock issuance becomes the exclusive initial subscriber, and bears the legal obligation to pay the entire amount that the company seeks to raise through the subscription offering (Company Code, Art. 63 Para. 1).

The election of the directors at incorporation, accounting advisors at incorporation, auditors at incorporation and accounting auditors at incorporation shall be made by the resolution of an organizational meeting (Company Code, Art. 88).

**[E] Registration of Incorporation.** Upon registration of incorporation, a stock company is formed and becomes a juridical person (Company Code, Art. 49), and the promoters and subscribers who made the required capital contributions become shareholders (Company Code, Art. 50, Para. 1, Art. 102, Para. 2). The provisions regarding specific registration requirements (business purpose, company name, etc.) are set forth in Company Code, Art. 911, Para. 3.

**[iii] Liability Relating to Incorporation.** If the value of the Properties Contributed in Kind at formation of a Stock Company is substantially short of the value specified or recorded in the articles of incorporation with respect to such Properties Contributed in Kind (or if there is any amendment of the articles of incorporation, the value so amended), the incorporators and Directors at Incorporation shall be jointly and severally liable to such Stock Company

for the payment of the amount of such shortfall (Company Code, Art. 52, Para. 1, See also Para. 2).

Promoters, as well as initial directors and/or auditors (depending on the corporate governance system) appointed at the time of incorporation, also bear the responsibility to pay compensatory damages to the company for any economic loss resulting from their dereliction of duty during the incorporation process (Company Code, Art. 53 Para. 1). The applicable duty of care regarding the above is based on a negligence standard, although upon the consent of all shareholders, it is permissible to grant a release to the negligent actor or actors (Company Code, Art. 55). Furthermore, in instances of bad faith or grossly negligent dereliction of duty, promoters and/or auditors (depending on the corporate governance system) are jointly and severally liable even to third parties for compensatory damages (Company Code, Art. 53 Para. 2, Art. 54).

Where incorporation of the stock company was frustrated during the formative process, even absent negligence and regardless of whether or not the articles of incorporation and bylaws were properly registered, the promoters are jointly and severally liable for the entire amount of the various costs incurred in incorporation (Company Code, Art. 56). Finally, a sham promoter (*giji hokkinin*), a person or entity whom, where subscription has been solicited pursuant to Company Code, Art. 57 Para. 1, has consented to the recordation of his name or trade appellation and represented his sponsorship in the formation of the company, etc., bears the same liability as other promoters (Company Code, Art. 103 Para. 2).

**[iv] Invalidation of Incorporation.** The Company Code, in the interest of providing security and stability for the transaction of business activities, contains provisions that allow certain persons to bring actions to invalidate the incorporation of stock companies. However, the specific grounds for having a company's incorporation adjudged to be invalid are not expressly prescribed in the Act. In general, the following are considered to be grounds justifying judicial invalidation of incorporation: (1) the registered articles and bylaws omit one or more mandatory terms, or in the alternative, are prescribed in a way as to be legally defective; (2) there was no collective resolution reached by the promoters regarding the specific details of the initial stock issuance; (3) the required capital investment, or in the alternative, the transfer of assets equivalent in value to the minimum capital requirement, was not made at the time of incorporation; (4) failure to convene the required initial general meeting of shareholders; and (5) the registration of the incorporation itself was legally defective.

Actions to invalidate an incorporation may only be brought by stockholders, directors (depending on the corporate governance system, auditors, or *shikkoyaku* n7), or liquidators (Company Code, Art. 828, Para. 2, Item 1), and must be brought within two years of the company's date of incorporation (Company Code, Art. 828, Para. 1, Item 1); in invalidation actions the company is the defendant (Company Code, Art. 834, Item 1).

Where there has been a final judicial determination invalidating a company's incorporation, the decision is legally effective as against the world, extending even to third parties (Company Code, Art. 838); however, the invalidation has no retroactive effect (Company Code, Art. 839).

**[c] Stock and Stockholders**

**[i] Overview.** A stock company, in a manner consistent with the substantive character and quantity of stock that is held, must provide equitable treatment to its stockholders regarding the rights and obligations they possess (basic principle of shareholder equality, Company Code, Art. 109). Provisions inserted into the bylaws, resolutions made at a general meeting of shareholders, executive acts of representative directors, and any other attempts to introduce corporate standards that deviate from the principle of equal treatment are in contravention of the law and are void (Ohan-Tai 11.10.12 *Minshu* 1.581).

Under the former Commercial Code, there were provisions creating exceptions to the basic principle of shareholder equality concerning types of stock, rights of "required-minimum share" shareholders (explained below), etc., but the

current company law clearly indicates that companies may create stock of different classes (*shurui kabushiki*), and that stock companies may, upon the approval of their shareholders by a special resolution and as prescribed in the bylaws, to treat their stockholders unequally regarding such rights as the right to receive distributions of surplus retained earnings, the right to receive distributions of residual assets, the right to vote at shareholders' general meetings, etc. (Company Code, at Art. 109 Para. 2, Art. 309 Para. 4). These rights are considered to be based on the substantive character of the class of stock that is held by the shareholder, and no longer are characterized as exceptions to the principle of shareholder equality.

**[ii] Rights and Obligations of Shareholders.**

**[A] Various Types of Shareholder Rights and Obligations.** Shareholders have various types of rights, which can be broadly classified as belonging to one of two categories, rights relating to the shareholder's individual interest (*jieki ken*) and rights relating to the common interest (*kyoeki ken*), depending on the primary objective of the right at issue. Rights relating to the shareholder's individual interest are those rights that are concerned with the individual shareholder's objective of deriving economic benefit from the company, including the right to demand the distribution of surplus retained earnings as dividends (*joyokin bunpai seikyuken*, Company Code, Art. 105 Para. 1 Item 1), the right to demand the distribution of residual assets (*zanyo zaisan bunpai seikyuken*, Company Code, Art. 105, Para. 1, Item 2), right to new stock subscription warrants (*shinkabu hikiukeken*, Company Code, at 202 Para. 1), appraisal rights (*kabushiki kaitori seikyuken*, Company Code, Art. 469; *see also* Arts. 116, 785), etc. In contrast, rights relating to the common interest refer to those rights that relate to the common shareholder goal of participating in the company's decision-making process, and include the right to make proposals (*teianken*, Company Code, Art. 303), voting rights (*giketsuken*, Company Code, Art. 105 Para. 1 Item 3) the right to ask questions (Company Code, Art. 314) at shareholders' meetings, the right to demand cancellation of a resolution (Company Code, Art. 831), the right to bring a shareholders' derivative action (*daihyo sosho teikiken*, Company Code, Art. 847), the right to enjoin the illegal acts of directors (Company Code, Art. 360), the right to examine the company's accounting documents (*choboetsuranken*, Company Code, Art. 433), the right to demand the dissolution of the stock company (Company Code, Art. 833), etc.

Furthermore, it is also possible to classify stockholder rights on the basis that they are basic shareholder rights (*tandoku kabunushi ken*), which are rights that may be exercised by any shareholder with even one share of stock, and "required-minimum share shareholder" rights (*shosu kabunushi ken*), which are rights that may only be exercised by shareholders who own a predetermined percentage or quantity of stock shares, as prescribed in the bylaws. Rights relating to a shareholder's individual interest all belong to the category of basic stockholder rights; however, rights relating to the common interest may belong to either the basic or required-minimum share stockholder right category.

The responsibility of each shareholder for the company's debts is limited to his obligation to contribute capital to the company in exchange for his shares of stock, an amount that is limited to the purchase price of his company stock holdings (Company Code, Art. 104).

**[B] The Type and Nature of Stocks.** If prescribed in the bylaws (Company Code, Art. 107 Para. 2), a stock company, in regard to the substantive nature of its stock, has the power to issue: (1) transfer-restricted stock (*jotoseigen kabushiki*, Company Code, Art. 2, Item 17); (2) stock with a put option against the company, or stock with a right of appraisal (*shutoku seikyukentsuki kabushiki*, Company Code, at Item 18); and (3) stock with a reacquisition option owned by issuing company (*shutoku jokotsuki kabushiki*, Company Code, at Item 19); as prescribed in Article 107, Paragraph 1 of the Company Code. The second and third types of stock listed above permit an acquisition demand for the company to purchase the stock from its owner--in the case of (2), by the shareholder, in the case of (3), by the company.

Furthermore, a stock company can also issue stock of a different nature from any of the above, called specified stock (*shurui kabushiki*, Company Code, Art. 108, Para. 1). In order to issue specified stock, it is necessary to prescribe the relevant terms in the bylaws setting forth the nature and total quantity of the specified stock that the company intends to

issue (Company Code, Para. 2).

Where the stock company issues specified stock and this has a disadvantageous effect on the rights and interests of some other existing type of company stock, it is generally necessary to conduct a meeting of the adversely affected stockholders and come to a determination resolving the matter (Company Code, Art. 322, Para. 1, Item 1); however, it is permissible to prescribe terms in the bylaws that make a general meeting of specified stockholders unnecessary in the aforementioned situation (Company Code, Art. 322, Para. 2).

**[C] Prohibition on Certain Payments or Distribution of Assets by Stock Companies to Shareholders in Connection with the Exercise of Shareholder Rights.** A stock company is prohibited from making payments or distributing assets from its own accounts or from a subsidiary's accounts in connection with the exercise of shareholder rights (Company Code, Art. 120, Para. 1). If a company makes payments or distributes assets in violation of this provision, the payment or asset distribution is void and the recipient of the payment or asset distribution must make restitution to the company for the amounts received (Company Code, Art. 120, Para. 3). If a director or directors, etc., have acted in violation of this prohibition on improper giving of payments or asset distribution on a *quid pro quo* basis to a shareholder or shareholders, all of them are jointly and severally liable to compensate the company for the amount that was improperly distributed (Company Code, Art. 120, Para. 4, negligence liability). The directors may be released from this liability upon the approval of all stockholders (Company Code, Art. 120, Para. 5). The issuance of payments or asset distribution by the company that is in violation of the law is also subject to penal sanctions as prescribed in the Code (Company Code, Art. 970). It is worthwhile to note that the above legal provisions are specifically intended to guard against corporate extortionists (*sokaiya*), a stockholder-related problem that is somewhat distinctive to Japan.

**[iii] Stock Certificates and the Shareholder Registry.**

**[A] Stock Certificates.** The stock certificate is a security document that stipulates the status and rights of its holder. A stock certificate contains: (1) the name of the company; (2) the stock quantity; (3) any restrictions on the transfer of the stock, if applicable; (4) the type and nature of the stock, if a specified stock; and (5) the signature, or sign and seal, of the representative director (in the case of companies with board committees, the *shikkoyaku*); *see* Company Code, Art. 216.

Under the Company Code, a stock company is only authorized to issue stock certificates if it is prescribed in its articles and bylaws (*see* stock certificate issuing companies; Company Code, Art. 214). In other words, not issuing stock certificates can be considered the general rule. Conveyance of a stock certificate by the issuing company requires delivery of the stock certificate to the stock acquirer (Company Code, Art. 128, exceptions set forth in Art. 129 Para. 2).

Regarding listed companies, it should be noted that pursuant to the "Act Concerning the Transfer of Corporate Bonds and Stocks, Etc." enacted in 2004, stock certificates in their present form were completely abolished on January 2009. The stock information was computerized as part of the movement toward "paperless" stock certificates.

**[B] Shareholder Registry.** Generally speaking, stocks are transferable interests not subject to special restraints, and as a result the identities of a stock company's shareholders are subject to change. In order for stock companies to make distributions of retained surplus earnings as dividends or notify shareholders regarding general meetings, etc., a stock company must be assured of having accurate records containing the necessary information regarding its shareholders and the stock certificates in circulation, because this information is the basis for the company's dealings with its shareholders. The shareholder registry is the stock company's record containing the necessary information. The company law permits stock companies to identify their shareholders as those persons who are listed in the shareholder registry as of a predetermined reference date, which allows the companies to establish uniform procedures while assuring impartial treatment of its shareholders.

A shareholder registry contains the names of a company's shareholders as well as the legally prescribed details regarding their stock holdings, such as the type and number of stock shares, etc. (Company Code, Art. 121); the stock

company must maintain its shareholder registry either at its principal office or at the business office of the person who has been designated by the company as the custodian of the shareholder registry (Company Code, Art. 125).

A stockholder who is not listed in the shareholder registry (e.g., having purchased or inherited the stock subsequent to the most recent regular update of the registry) is not permitted to lodge a protest with the company regarding his or her omission from the registry, and demand recognition of his status as a stockholder (Company Code, Art. 130). However, absent bad faith or gross negligence, a company bears no responsibility to acknowledge persons not listed in its shareholder registry as shareholders (See Company Code, Art.126, Para. 1).

Regarding title transfers (*meigi kakikae*), a stock certificate issuing company is only required to ascertain that a person has possession of a stock certificate it has issued to consider that person a stockholder; however, for stock companies that do not issue stock certificates, the proposed conveyor and the conveyee must cooperatively establish the title transfer in order for it to be recognized by the company (Company Code, Art. 133). As a general rule, title transfers are recognized by stock certificate issuing companies upon presentation of a stock certificate by the acquirer to the company (*see* Company Code Implementation Regulations).

**[iv] Transfer of Stocks.**

**[A] Right to Transfer Stocks.** As a general rule, stocks may be transferred without being subject to any special restrictions (Company Code, Art. 127). Juridical acts such as sale, gift, exchange, etc., constitute valid methods of transferring stock. However, the extent to which stock transfer rights may be freely exercised can differ depending on whether or not such rights are restricted.

**[B] Transfer-Restricted Stocks.** Certain types of Japanese companies, such as *dozoku gaisha* (companies whose equity owners are close personal acquaintances, usually family members or relatives) and *gomei gaisha* (partnership companies) inherently place a great deal of importance upon the personal connections and characteristics of their equity owners. These types of companies (so-called "exclusive companies" or *heisateki-na kaisha*), consider it highly important to be able to exercise control over their equity-holding members' ability to transfer their stock to nonmembers, and in response to this the new Company Code contains provisions for the issuance of so called "transfer-restricted stock," (*joto-seigen kabushiki*) which are not transferable without proper approval from the company (Company Code, Art. 2 Item 17). Companies whose bylaws permit the issuance of transfer-restricted stock only are called non-public companies (*hikokai kaisha*).

A stockholder seeking to transfer his transfer-restricted stock (or a stockholder who has transferred the stock without receiving prior approval) to a third party must request the company's consent approving the transfer (Company Code, Arts. 136, 137); however, if the proposed transfer of transfer-restricted stock is rejected by the shareholders at their general meeting (or by the board of directors, if applicable based on the corporate governance system), then the company, pursuant to a special resolution (the person seeking the transfer approval may not vote on this resolution; *see* Company Code, Art. 140), must decide either to purchase the transfer-restricted stock itself, or in the alternative, designate some person to acquire all or some portion of the stock at issue (Company Code, Art. 140 Para. 1 Item 4).

The purchase price of stock is normally agreed upon through negotiations between the transferor and the company or the designated acquirer, but where such negotiations are not conducted or prove unsatisfactory, a petition requesting a judicial assessment of the stock's value may be filed (Company Code, at 144, Para. 2). If no such request is made, the value of the company's net assets, calculated on a *pro rata* basis relative to each individual share of company stock and multiplied by the number of shares that are being transferred, will be the basis for assessing the stock purchase price (Company Code, Art. 144 Para. 5).

**[C] Legal Restrictions on Stock Transactions**

**[I] Restrictions on the transfer of the right to become a shareholder and on stock transfers prior to issuance.**

Under the Company Code, a shareholder or prospective shareholder's transfer of his right to become a shareholder (*kenri-kabu*) to another person is not a transaction for which the company can be held accountable (Company Code, Art. 35; Art. 50 Para. 2; Art. 63, Para. 2; Art. 208 Para. 4); additionally, regarding companies that issue stock certificates, an attempted transfer of stock before the company issues the stock certificate for that stock does not affect any relationships as against the company (Company Code, Art. 128 Para. 2). However, this legal restriction does not apply where the company has neglected to issue its stock certificates in a timely manner (Supreme Court, 1972.11.8, *Minshu* 26.9.1489).

**[II] Reacquisition of company stock.** As a general rule, the company law permits companies to reacquire their own stock if a resolution approving the reacquisition and setting a time period (not to exceed one year) during which the company must take action is passed at either a general or a special meeting of shareholders (Company Code, Art. 156). Additionally, companies with a board of directors may set terms in their articles and bylaws authorizing the reacquisition of company stock through market transactions, etc., subject to a board decision to that effect (Company Code, Art. 165). However, in reacquiring it own stock, the company cannot spend an amount in excess of its retained earnings distributable as dividend payments (Company Code, Art. 461 Para. 1 Arts. 2-3).

**[III] Retention of company stock.** Pursuant to the so-called "acceptability of treasury stock" (*kinko-kabu no yonin*) principle, a stock company has the right to retain shares of its own stock as so-called treasury stock, and is not obligated to retire or dispose of its own stock once it enters its treasury, nor is the company subject to any special time or quantity-related limitations regarding retention of treasury stock; however, once it becomes treasury stock, stock ceases to be characterized as an asset (Accounting Regulations Para. 1082 Item 5), and voting and dividend distribution rights are not recognized for treasury stock (Company Code, Art. 308 Para. 2, Art. 453). Additionally, the disposal of treasury stock is treated as being the same as the issuance of new stock under the company law, and is regulated in the same way as a new stock offering (Company Code, Art. 199, etc.).

**[IV] Prohibition on acquiring the stock of the parent company.** As a general rule, a subsidiary company is prohibited from acquiring stock in its parent company (Company Code, Art. 135 Para. 1). While special circumstances such as corporate division, merger and the complete transfer and absorption of another company's operations may be considered circumstances that justify permitting exceptions to the rule, even then the subsidiary must divest itself of the parent company's stock within a reasonable time period (Company Code, Para. 2). Voting rights of the stockholder are not recognized for a subsidiary company holding stock in its parent company (Company Code, Art. 308 Para. 2, Para. 3).

**[V] Special statutory restrictions.** The Antimonopoly Act prohibits or limits the transfer or ownership of stock if that transfer or ownership threatens to create a private monopoly, or constitutes an unreasonable restraint of trade (Antimonopoly Act, Arts. 9-11, 14). In addition, there are statutory provisions that restrict the transfer of stock of companies in the telecommunications and daily newspaper industries.

**[VI] Restrictions on stock transfers based on contract.** Regarding the enforceability of private contracts purporting to place restrictions on stock transfers, the standard as identified by scholarly theory customarily considers the key point of distinction to be whether or not the issuing company is a contractual party. That is to say, contracts between the company and a stockholder are susceptible to being used to circumvent legal safeguards and thus are void as a general rule, but contracts between stockholders or between a stockholder and a third party are valid as a general rule. Case law relating to the shareholder-employee stock company ownership system indicates this is something of a problem area legally (Supreme Court, 1995.4.25, *Saibanshuminji* 175.91).

**[d] The General Meeting of Shareholders**

**[i] Establishing a System of Corporate Governance and the Distribution of Management Authority--A Flexible Approach to Organizing a System of Corporate Governance.** A stock company's governance system consists of a supreme decision-making body (the general meeting of shareholders), an executive management body

(board of directors, etc.) and an auditing body (auditors, etc.) with important decision-making powers relating to the company being divided between these governing bodies.

As to what kind of corporate system of governance is best implemented by a particular company, the Company Code takes consideration of factors such as the presence of restrictions on stock transfers and the size of the company and makes a number of corporate governance options available; collectively the Company Code recognizes more than 30 types of corporate governance systems. Stock companies must, as a minimum, convene a general meeting of shareholders and appoint and retain at least one director (*torishimariyaku*).

**[ii] The General Meeting of Shareholders--Significance and Scope of Authority.**

**[A] Overview.** The general meeting of shareholders is a mandatory decision-making body comprised of the company's shareholders. It is the highest-ranking corporate governance body and can be said to represent the "will" of the company. If a company chooses not to appoint a board of directors, the general meeting of shareholders possesses the authority to pass resolutions regarding all matters as prescribed in the Company Code and relating to stock companies (Company Code, Art. 295 Para. 1). Conversely, if the company has established a board of directors, then the general meeting of shareholders possesses only the authority to pass resolutions regarding matters that are either reserved to them specifically under the Company Code or in the company's bylaws (Company Code, Para. 2); the authority to make all other decisions regarding company matters is delegated to the director (or board of directors, representative director, representative *shikkoyaku*, etc., as may be applicable).

**[B] Scope of Authority.** Corporate matters that are required to be decided by the general meeting of shareholders according to company law include the company's reacquisition of its own stock (Company Code, Art. 156 Para. 1, Art. 160 Para. 1), stock mergers (Company Code, Art. 180 Para. 2), selection and appointment of directors or auditors (Company Code, Art. 329 Para. 1) as well as their dismissal (Company Code, Art. 339 Art. 1), amendment of the articles and bylaws (Company Code, Art. 466), dissolution of the corporation (Company Code, Art. 471, Item 3), and corporate merger by absorption (*kyushu gappei*, Company Code, Art. Art. 795 Para. 1, consolidation into a new company, Art. 804, Para. 1). Provisions placed in the bylaws that purport to delegate the authority to resolve the above-mentioned matters to other governing bodies of the company are void (Art. 295 Para. 3).

In addition to those matters set forth above, companies without boards of directors may delegate other matters to the shareholders' decision-making authority, and even companies with a board of directors may choose to confer additional authority upon the shareholders meetings to resolve matters normally reserved to directors, etc., so long as the grant of additional authority is prescribed in the bylaws and in compliance with mandatory provisions of the law.

**[iii] Convening a General Meeting of Shareholders**

**[A] Authority to Call Shareholder Meetings.** For companies with a board of directors, the authority to call a general meeting of shareholders, as well as setting the date and time, location, agenda items to be discussed, etc., is generally possessed by the board. Pursuant to the board's decision to call a shareholder's meeting, the representative director (or representative *shikkoyaku*, if applicable) is responsible for notifying the stockholders and holding the meeting. In other types of stock companies, it is the director that performs this duty (Company Code, Arts. 298, 299, 491). Also, a required-minimum share stockholder who has a three percent or greater share of the voting rights based on his stock holdings, and has held this share of the voting rights continuously for at least six months, has the right to make directors that a general meeting of shareholders be convened (Company Code, Art. 297 Para. 1; in transfer-restricted stock companies, the requirement is to be a shareholder with three percent or greater of the total voting rights, *see* Company Code, Para. 2).

When all of the shareholders (or their proxies) assemble on their own accord and agree to hold a general meeting (a so-called plenary general meeting), the resolutions passed at such a meeting have the same force and effect as if passed at a formally convened general meeting of shareholders (Supreme Court Judgment, 1985.12.20, *Minshu* 39.8.1869).

**[B] Time and Location.** Convening an ordinary general meeting of shareholders is a mandatory responsibility for a stock company following the close of its fiscal year (Company Code, Art. 296 Para. 1), and this general meeting must take place within three months after the end of the accounting term for that fiscal year. Special general meetings of shareholders are not regularly scheduled, but rather are called upon necessity (Company Code, Para. 2). The Company Code does not place any conditions or restrictions on the location of the shareholders' meetings, although it is permissible to prescribe such terms in the bylaws.

**[C] Procedure for Convening a Shareholder Meeting.** To call the shareholders to convene for a meeting, the organizer must have sent notice of the meeting to each of the stockholders (excluding stockholders without voting rights) at least two weeks prior to the proposed meeting date, requesting them to convene (companies that are not public companies may shorten the minimum notice period to one week and companies without a board of directors may make such period much shorter) (Company Code, Art. 299 Para. 1). A notice to convene issued by a company with a board of directors must be in writing (Company Code, Art. 299 Para. 2 Item 3) and must state the proposed agenda for the meeting (Company Code, Art. 298 Para. 1 Item 2, Art. 299 Para. 4), but for companies without a board of directors, oral notification, such as by telephone, is sufficient as a method of notification.

A notice to convene for an ordinary general meeting of shareholders that is issued by a company with a board of directors must submit with it the company's financial statement and annual business report for the most recently concluded fiscal year. Also, companies with an auditor (*kansayaku*, *see* [6][b] *infra*) must submit an auditor's report, and companies with an accounting counselor (*kaikeisanyo*, *see* [5][a] *infra*) must submit an accounting counselor's report (Company Code, Art. 437).

**[iv] The Right of Shareholders to Propose Agenda Items.** For companies with a board of directors, shareholders whose stock holdings confer upon them one percent or more of the voting right, or shareholders who own at least 300 individual shares of stock, and have held either required quantity continuously for a minimum of six months, have the right to demand that the directors include a specific agenda item for discussion at a scheduled general meeting of shareholders, so long as the demand is made at least eight weeks (the prescribed period may be shortened in the bylaws) in advance of the date of the meeting (right to include agenda item (*gidaiteianken*), Company Code, Art. 303). Additionally, such stockholders also have the right to demand that a notice containing a summary of the proposed agenda item be sent to the company's other stockholders (right to propose agenda (*gi'an-teianken*), Company Code, Art. 305). Regarding either of these rights, if the company does not have a board of directors then the aforementioned requirement to possess the specified minimum quantity of stocks does not apply, and the right is exercisable by any stockholder. In addition, any stockholder in the latter type of company may attend a general meeting of shareholders and request, at the meeting, to have their agenda items included on the agenda (Company Code, Art. 304).

**[v] Voting Rights.** Generally speaking, all stockholders have voting rights (*giketsuken*), a term referring to the right to attend shareholders' general meetings and the right to participate in the decision-making process in passing resolutions, with one vote per share or unit of stock owned commonly being the rule (Company Code, Art. 308 Para. 1). As exceptions to this general rule, voting-restricted stocks (*giketsuken seigen kabushiki*, Company Code, Art. 108 Para. 1 Item 3), treasury stocks (*kinko-kabu*, Company Code, Art. 308 Para. 2), cross-held stocks (*sogohoyu no kabushiki*; *see* Company Code, Art. 308 Para. 1), and fractional-share stocks (*tangen-miman kabushiki*, Company Code, Para. 1 proviso) have no voting rights that may be exercised (the last of these, fractional-share stocks, inherently have no voting rights regardless of special considerations).

Voting rights may be exercised by proxy (Company Code, Art. 310 Para. 1); also, under certain specific circumstances, alternative means of voting, such as in writing or by electromagnetic means, may be used to exercise voting rights (Company Code, Art. 298 Para. 1 Item 3 and 4;*;* Art. 298, Para. 2; Art. 311; Art. 312), in which case the company has the responsibility of providing the necessary information regarding how to vote to its stockholders.

**[vi] Proceeding with the Meeting and Passing Resolutions.** At the general meeting of shareholders, the directors, accounting counselors, auditors, or *shikkoyaku* are required to provide explanations regarding an agenda item

that is the subject of shareholder inquiry (duty of director, etc., to provide explanation, Company Code, Art. 314). If the directors, etc., refuse to provide an explanation and disregard a stockholder's appropriate exercise of his right to ask questions regarding the company, this constitutes a procedural error, and may be grounds for cancellation of any resolution that is passed despite this failure to explain (Company Code, Art. 831 Para. 1 Item 1).

Shareholder approval of corporate resolutions is generally pursuant to a one vote per share of stock, majority vote arrangement; because the number of times a stockholder may vote depends on his quantity of shares with voting rights, "the majority vote" is based on quantity of shares of voting rights exercised in support, and not necessarily the number of persons voting in support. Depending on the terms and conditions of the vote required for passage, shareholder resolutions can be characterized as ordinary, special and extraordinary resolutions:

Ordinary resolution (*tsujo ketsugi*): this method is used to make decisions regarding matters that are not subject to any special conditions under Company Code or the company bylaws. In order for an ordinary resolution to be valid, the meeting must be attended by shareholders who cumulatively hold stock shares accounting for more than one-half of the total voting rights (*teisoku-su*, i.e., a quorum) and the resolution must be ratified by a majority of the votes of the shareholders present at the meeting where the shareholders holding a majority of the votes of the shareholders who are entitled to exercise their votes are present. (Company Code, Art. 309 Para. 1). The minimum requirements for a quorum may be modified in the bylaws (*see* Company Code, Art. 341). Matters that are subject to decision by ordinary resolution include the election or dismissal of directors, accounting counselors, auditors and/or accounting auditors (Company Code, Art. 329 Para. 1), resolutions regarding the compensation of board members and other executives and officers (Company Code, Art. 361 Para. 1, Art. 379 Para. 1), among others.

Special resolution (*tokubetsu ketsugi*): in order to pass a special resolution, the general meeting must be attended by shareholders who cumulatively hold stock shares accounting for more than one-half of the total voting rights (this minimum requirement for a quorum may be reduced to one-third in the bylaws), and ratification requires at least a two-thirds majority of the votes in favor of the resolution. It is also permissible to insert additional conditions in the bylaws, such as requiring a greater than two-thirds majority for ratification, or votes in excess of a specific predetermined quantity (Company Code, Art. 309 Para. 2). In either case the standard for sufficiency of shareholder participation and votes is based on the quantity of exercisable voting rights held by the attendees (*giketsukensu kijun*). Matters that are subject to decision by special resolution include consolidation of stock shares (Company Code, Art. 180 Para. 2), release of board members and/or executives from legal liability resulting from their negligent breach of duty to the company (Company Code, Art. 425 Para. 1), capital reduction/stock retirement (Company Code, Art. 447 Para. 1), amendment of the articles of incorporation and bylaws (Company Code, Art. 466), and the company's consolidation with another company (*shinsetsu gappei*, Company Code, Art. 804 Para. 1), etc. (Company Code, Art. 309 Para. 2 Items 1-12).

Extraordinary resolution (*tokushu ketsugi*): this is a decision-making process subject to even stricter requirements than special resolutions (Company Code, Art. 309 Para. 3). To pass an extraordinary resolution, one-half or more of the shareholders (i.e. to create a quorum more than half the physical shareholders, and not merely shareholders possessing more than half the voting rights, must be present, a standard called *tosu kijun*) must attend the general meeting and vote in favor of the proposed resolution by a minimum two-thirds majority of the vote (the vote itself follows the usual *giketsuken-su kijun* standard).

Either requirement may be subject to additional conditions if so prescribed in the bylaws; matters that must be decided by extraordinary resolutions include the amendment of the bylaws to allow the issuance of transfer-restricted stock (Company Code, at Art. 108 Para. 1 Item 2) and one-time ratification of a merger agreement (Company Code, at Arts. 783, 804). There is also an extraordinary resolution mandated by statute, which is a stockholder proposal for the amendment of the articles and bylaws to create different classes of company stock (e.g., specified stock), that requires approval by half the shareholders (under *tosu kijun*) by three-fourths majority of the votes (under *giketsuken-su kijun*), with either requirement subject to additional conditions if so prescribed in the bylaws; (Company Code, at Art. 309

Para. 4).

**[vii] Stockholder Decisions and the Majority Vote System: Restrictions and Safeguards Against Abuse.** A decision-making process that mandates adopting the decisions of the voting majority (based on share of voting rights, which in turn largely corresponds to equity share) requires implementing protective measures to safeguard the interests the voting minority. For this reason, the Company Code contains provisions such as the dissenting stockholder's right to exercise a put option, or right of appraisal, against the company (Company Code, Arts. 116, 469, 785, 797, 806), cumulative voting for the election of directors (Company Code, Art. 342) and the right of stockholders to demand the dismissal of such officer by filing an action (Company Code, Art. 854).

**[viii] Defective Shareholder Resolutions.**

**[A] Cancellation of Resolution (*ketsugi-torikeshi*, Art. 831 *et seq.*).** Where there are only comparatively minor defects occurring in the process of passing a shareholders' resolution, such as formal or procedural errors, having the resolution judicially invalidated based on the defect can create practical problems for a company that are disproportionate in comparison to the error made, especially with the passage of time; therefore, the company law limits the ability of parties to bring actions to cancel shareholders' resolutions by instituting requirements for party standing, prescriptive extinction, etc., and making it only possible to cancel shareholders' resolutions by judicial order (Company Code, Art. 831 Para. 1). Upon a final judgment ordering cancellation, a resolution passed at a general meeting of shareholders not only becomes void, it is retroactively made *void ab initio* as against the world (Company Code, Art. 838). Grounds for judicially invalidating a shareholders' resolution are: (1) the procedure for convening the meeting, or the method by which the resolution was passed, violates statutory law or the company's bylaws; (2) the purported exercise of decision-making powers by the shareholders regarding the subject matter of the resolution violates prescribed conditions in the bylaws; and (3) a shareholder with a special interest in the approval of the resolution exercised his voting rights to have it passed, resulting in the passage of a resolution unjust to the other shareholders (Company Code, Art. 831, Para. 1).

An action for cancellation of a shareholders' resolution must be brought within three months of the resolution's date of passage, with a shareholder, director, auditor or liquidator acting as the plaintiff and the company as the defendant (Company Code, Art. 834), and may be brought at the district court with jurisdiction over the location of the company's principal office (Company Code, Art. 834). As an illustrative example, the Supreme Court has held that a shareholder who failed to attend the shareholders' meeting at which a certain resolution was passed because he did not receive the company's notice apprising him of the meeting is nevertheless entitled to bring suit to cancel the resolution, because the defectively passed resolution affected all of the shareholders whether they attended the specific shareholders' meeting or not (Supreme Court Judgment, 1967.9.28, *Minshu* 21.7.1970).

However, a court may find that the method of approving a disputed resolution, or other procedures implemented at the shareholder's meeting, did violate some statutory provision or company bylaw but nevertheless decide to dismiss the action for invalidation, if the court determines from the facts that the violation at issue was not material and did not affect the propriety of the subject matter of the resolution (discretionary dismissal, Company Code, Art. 831, Para. 2).

**[B] Invalidity of Resolution.** A shareholders' resolution that purports to authorize illegal activity (e.g., a resolution approving an illegal financial statement prepared by the company) is *void ab initio*. The inherently void nature of such a resolution may be asserted by any person at any time, and when brought as a legal action, it constitutes a claim for judicial confirmation of the resolution's invalidity (Company Code, Art. 830 Para. 2). A judgment of invalidity obtained as a result of this type of legal action is valid and enforceable as against the world (Company Code, Art. 838).

**[C] Nonexistence of Resolution.** There are instances, such as where a shareholder resolution is referenced only vaguely in the minutes of the general meeting of shareholders or in the corporate records, or where the shareholders' meeting was convened by a person without the necessary authority, that the valid passage of a particular resolution is not verifiable. As a general rule, anyone, at any time and by any method, may assert that there is insufficient evidence to

show that a particular resolution was ever passed, and if necessary may bring an action to establish the resolution's nonexistence. The procedure for filing and litigating such an action, and the legal consequences thereof, is basically the same as that of a claim for a judicial confirmation of invalidity as discussed above (Company Code, Art. 830 Para. 1, Art. 838).

In an interesting case, the Supreme Court held that where a shareholders' resolution later judicially adjudged as nonexistent had confirmed the appointment of certain persons as the board of directors, and that board of directors had elected a representative director, and the representative director had convened a general meeting of shareholders pursuant to the board's putative right to convene stockholder's meetings, and a resolution had been passed at the subsequent general meeting of shareholders that seemed to prove that the stockholders had accepted the board, excepting special cases such as the convening of a plenary general meeting of shareholders, the nonexistence of the original resolution nevertheless made everything arising from the nonexistent resolution null and without effect, and thus the board was not considered to have been validly elected, or were any of its actions of legal consequence (Supreme Court Judgment, 1978.7.10, *Minshu* 32.5.888).

**[e] Stock Company Directors.**

**[i] Creation of an Executive Management Body.** Assuming a stock company only has one director, the management decisions of the company are made by that director, who is also the company's official representative. If there are multiple directors, decisions are made by the directors collectively, through a simple majority vote system; as to who is the official representative of the company, by default each and every one of the directors possesses this capacity, but in the alternative a representative director (*daihyo torishimariyaku*) may be elected from among the directors (Company Code, Art. 349).

Stock companies that are public companies and companies with auditors or companies with board committees are required to appoint and retain a board of directors consisting of three or more directors (Company Code, Art. 327 Para. 1; Art. 331, Para. 4). This board of directors makes the company's executive decisions, and elects a representative director or executive managing director (*gyomu shikko torishimariyaku*) from among the board members to serve as the executive officer. The executive managing director has the authority to make and execute decisions concerning the general management of the company.

Finally, the executive management of a company with board committees is conducted by the *shikkoyaku*, who is appointed by the board of directors, and the *shikkoyaku* is also responsible for making and executing business decisions pursuant to the authority delegated to him by the board of directors (Company Code, Art. 418).

**[ii] Directors**

**[A] Qualifications of Directors.** Under the Company Code, a director of a company (*torishimariyaku*) n8 is not required to be a stockholder of that company, nor may the company prescribe such a requirement in its bylaws (division of ownership and management, Company Code, Art. 331 Para. 1 Item 2). However, companies that are not public companies are not subject to this rule (Company Code, *see* proviso to Para. 2).

Items 1 through 4 of Article 331, Paragraph 1 stipulate rules concerning persons who do not qualify to become stock company directors (juridical persons, adult wards of guardians, warranties of curators, etc.; however, the Company Code now excludes persons adjudged bankrupt from statutory disqualification). Additionally, the positions of auditor and director may not be combined in one person (Company Code, Art. 335 Para. 2).

**[B] Appointment and Dismissal of Directors.** A stock company is required to appoint at least one director (Company Code, Art. 326 Para. 1). However, companies with a board of directors (*torishimariyakukai secchi kaisha*) are required to have a board with three or more directors (Company Code, Art. 331 Para. 4).

The term of appointment for a director is required to expire at the conclusion of the final ordinary general meeting of shareholders held during a fiscal year, and in any case is not to exceed two years; however, by shareholder resolution or as prescribed in the bylaws, it is possible for a company to shorten the default statutory term (Company Code, Art. 332 Para. 1; for companies with board committees this is one year, *see* Company Code, Para. 3; *see also* Para. 4). A non-public company may extend the term for ten years (*see* Company Code, Para. 2).

Directors are elected and appointed by the company's stockholders at the general meeting of shareholders (Company Code, Art. 329 Para. 1), the election being subject to special quorum requirements (Company Code, Art. 341) and cumulative voting conditions, which may be excluded by the articles and bylaws (Company Code, Art. 342).

The dismissal of directors is also decided by the company's shareholders at their general meeting, by ordinary resolution (Company Code, Art. 339 Para. 1, Art. 341). If there is a specified term of appointment and a director is dismissed prior to the expiration of his term without adequate cause, the company is required to pay the director any compensatory damages that arise from the early dismissal (Company Code, Art. 339 Para. 2).

Even where a resolution for dismissal has not been passed, if a director has acted improperly, or, under the director's management, the company has materially violated the law or company bylaws, shareholders with stock shares accounting for three percent or more of the company's voting rights, or required-minority share shareholders with three percent or more of the company's outstanding shares of stock (and in either instance, having possessed the required stock interest continuously for at least six months), may bring an action for the director's dismissal (Company Code, Art. 854 Para. 1; for non-public stock companies, *see* Para. 2).

**[C] Executive Management.** Unless otherwise specifically prescribed in the bylaws, it is the role of the director to make management decisions for the stock company, excluding companies with a board of directors (Company Code, Art. 348 Para. 1). If there are two or more directors, the management decisions of the stock company, unless otherwise specifically prescribed in the bylaws, are made by director vote, with a simple majority prevailing (Company Code, Art. 348 Para. 2).

Decisions generally within the scope of the authority of directors include: 1) the hiring and dismissal of managers (*shihainin*); 2) the establishment, relocation and closing of branch offices; 3) the decision to convene a general meeting of shareholders; and 4) the creation of systems for internal company management (Company Code, Art. 348 Para. 3). However, a stock company may not attempt to delegate authority to its directors to release company officers and executives of legal liability, and any provision in the bylaws purporting to grant such authority is void (Company Code, Art. 348 Para. 3).

Where there is only one director, that director is the official representative of the company (Company Code, Art. 349 Para. 1; it is also possible to make someone who is not a director the official representative). Where there are two or more directors, each of the directors is an independent official representative of the company (Company Code, Art. 349 Para. 2). Stock companies (excluding companies with a board of directors) may choose, either by self-selection among the directors or by shareholder resolution as prescribed in the bylaws, one representative director (*daihyo torishimariyaku*) from among the directors (Company Code, Art. 349 Para. 3). The representative director has sole authority to represent the company and to make decisions relating to both legal and extralegal matters, that are necessary to manage the company's business (Company Code, Art. 349 Para 4).

**[iii] Boards of Directors**

**[A] Overview.** The board of directors is a decision-making body comprised of all the directors of a stock company.

A stock company can establish a board of directors by prescribing it in the bylaws (Company Code, Art. 326 Para. 2).

Establishment of a board of directors is mandatory for public companies, companies with auditors and companies with board committees (Company Code, Art. 327 Para. 1). Companies with a board of directors, whether their decision to establish a board was voluntary or mandatory, are required to elect three or more directors to the board (Company Code, Art. 331 Para. 4).

**[B] Boards of Directors--Scope of Authority.** A board of directors, excluding those matters that are reserved to the decision-making powers of the shareholders by law or pursuant to the company's bylaws (Company Code, Art. 295 Para. 2), makes the management decisions on behalf of the company regarding its business (Company Code, Art. 362 Para. 2 Item 1). Under the Company Code, matters that are specifically ascribed to the board for resolution include calling a general meeting of shareholders (Company Code, Art. 298 Para. 4), stock splits (Company Code, Art. 183, Para. 2), the selection or dismissal of the representative director (Company Code, Art. 362 Para. 2 Item 3), and approval of the company's financial statements or business reports as well as any supporting documents attached as appendices thereto (Company Code, Art. 436 Para. 3), etc.

In a company with a board of directors, the authority to make management decisions belongs entirely to the board, but the board must choose to appoint a representative director or executive managing director and delegate to that person the independent authority to carry out board resolutions and make ordinary executive decisions for the company (Company Code, Art. 363 Para. 1). However, certain matters as prescribed by law must be decided by the board, and may not be left to the discretion of the representative director or equivalent company executive. Moreover, Article 362, Paragraph 4 of the Company Code stipulates that deliberation over the fundamental aspects of important business issues are also exclusively within the scope of the board's authority (e.g. Item 1, the disposition and transfer of important assets; Item 2, assumption of substantial debt; Item 3, the hiring and firing of management-level employees). Among these, for large companies with a board of directors, the responsibility stipulated in Item 6, the creation of internal management systems, is a mandatory decision-making responsibility for the board and may not be delegated (Company Code, Art. 362 Para. 5).

**[C] Auditing Authority.** The board of directors has the authority to audit the acts of the representative director and of any of the other directors (as well as the company's employees in general) that relate to executive management matters (Company Code, Art. 362 Para. 2 Item 2). This auditing of management-related acts is not limited to investigating whether certain acts are in violation of the law (*tekihosei*), but also extends to investigating the propriety of acts in relation to the company's best interests (*datosei*).

**[D] Convocation and Operation of the Board.** A board of directors can generally be called together by any of the directors, but if the authority to call a board meeting is assigned to a particular director either in the bylaws or pursuant to an agreement reached by the board members, that director calls the meetings (Company Code, Art. 366 Para. 1). Even in the latter instance, if the director with the authority to call board meetings fails to do so, the other directors are recognized to have the right to request a board meeting or to convene a meeting (*shoshu seikyuken/shoshuken*, Company Code, Para. 2-3). Also, where necessary, an auditor also has the right to request or convene a board meeting (Company Code, Art. 383 Para. 2-3). Excluding companies with auditors and companies with board committees, the right of stockholders of companies with a board of directors to request and convene a board meeting is also recognized (Company Code, Art. 367).

Notices for the calling of a board meeting are required to be sent out at least one week prior to the scheduled meeting's date and time, but the minimum notice period may be shortened by prescribing the necessary terms in the bylaws (Company Code, Art. 368 Para. 1). It is not necessary to state the particulars of the agenda for the board meeting in the notice.

As a general rule, resolutions of the board are valid if more than one-half of the directors with a right to vote on the resolution attend and a simple majority of the directors in attendance vote in favor of the resolution, but companies may choose to add additional terms and conditions in the bylaws (Company Code, Art. 369, Para. 1). Each of the directors

has one vote per proposed resolution, and it is necessary to personally participate in the voting; unlike stockholders, directors may not have their vote exercised on their behalf by a proxy.

**[E] Conflict of Interest.** Regarding the decision-making authority conferred upon boards of directors, a director who has a conflict of interest (*tokubetsu rigai kankei*) with the company regarding a matter being decided by the board may not exercise his voting right (Company Code, Art. 369 Para. 2). A conflict of interest exists where a director has a significant social and/or economic individual interest in the outcome of a decision, such that it becomes difficult to have confidence in the director's ability to fully and faithfully execute his responsibility to the company in making an impartial decision. For example, there is a case where it was adjudged that a representative director who was the subject of a resolution regarding his dismissal had a conflict of interest and could not participate in the decision (Supreme Court Judgment, 1969.3.28, *Minshu* 23.3.645).

**[F] Defects in the Convening Procedure and Their Effect on Resolutions.** The company law does not specifically provide measures regarding procedurally defective board resolutions, but generally applicable legal rules render such resolutions invalid. It follows that at any time, any person, without resorting to litigation, may assert the invalidity of such a resolution. However, where a procedural defect in the passage of the resolution is acknowledged, but it can be shown that the defect did not negatively affect the passage of the resolution, the resolution is not invalid. For example, the Supreme Court has held that where the letters sent to board members notifying them of a board meeting were partially misdirected, and thus some directors failed to attend the meeting through no fault of their own (a clear procedural defect under the generally applicable rule) but that defect did not materially affect the subsequent board meeting because the absent directors could not have changed the outcome of the resolutions even if they had attended, despite the defect the passage of the resolutions was not defective, and therefore there was no reason to invalidate it (Supreme Court Judgment, 1969.12.2, *Minshu* 23.12.2396).

**[iv] Special Rules Regarding Board of Director Resolutions.** In making decisions concerning the disposition or transfer of important assets or relating to a large amount of corporate debt, where the board of directors of a stock company (excluding stock companies with board committees) has six or more directors on the board and one or more of those directors is an outside director (Company Code, Art. 362 Para. 4 Items 1-2), the board is permitted to create special rules regarding the passage of resolutions by appointing "special directors," so long as at least three such special directors are appointed; in that case, so long as more than one-half of the special directors attend a board meeting, a resolution regarding the above-referenced matters may be passed by a simple majority vote by those present (Company Code, Art. 373 Para. 1).

Outside directors are directors of a stock company who are not executive managing directors (*gyomu shikko torishimariyaku*), executive managers, management-level employees, or some other employees of the company or subsidiary company, and have not previously been executive managing directors, executive managers, management-level employees or some other employees of the company or subsidiary (Company Code, Art. 2 Item 15). The distinction is similar to that of executive and non-executive directors in Anglo-American corporation law.

**[v] Representative Directors**

**[A] Significance/Appointment/Dismissal.** In a stock company with a board of directors, the representative director (*daihyo torishimariyaku*) is the official representative of the company, and is a necessary instrumentality for the performance of the company's executive management functions. The acts of an official representative are executive management acts directed externally by the company. At board meetings, it is also permissible to appoint an executive managing director (*gyomu shikko torishimariyaku*) who does not have the authority to represent the stock company in external affairs, but performs only the executive management functions regarding internal company matters (Company Code, Art. 363 Para. 1 Item 2). Representative directors and executive managing directors are collectively referred to as executive managing directors. In other words, the term "executive managing director" can potentially have different meanings in terms of the scope of authority, and thus if that is the case for a stock company, it is well advised to clearly define the scope of the position in advance.

The representative director is elected from among the board members pursuant to a board resolution (Company Code, Art. 362 Para. 2). There is no express provision in the company law regarding a required minimum number of executive managing directors, representative directors, therefore as long as there is at least one it is acceptable.

It is a prerequisite for representative directors to be members of the board, and in the event that grounds for the discharge of a director from his corporate responsibilities are discovered, that director is also disqualified from being a representative director. A representative director may resign from his position at any time, and the board of directors may relieve the representative director of his or her position at any time (Company Code, Art. 363 Para. 2 Item 3).

**[B] Authority of Representative Directors.** The representative director is the stock company's authorized representative regarding company dealings with third parties, is in charge of internal executive management, and thus is a necessary, permanent official for stock companies with a board of directors (Company Code, Art. 362 Para. 3). Where there is more than one representative director, each of them individually has the authority to act as the company's official representative, and the scope of that authority extends to all executive acts pertaining to all judicial (that is, pertaining to legal matters) and non-judicial company decisions (Company Code, Art. 349 Para. 4), and any internal restrictions placed by a stock company upon its representative directors may not be asserted as a defense against third parties acting in good faith based on a representative director's representations (Company Code, Para. 5).

Even if the representative director's acts are objectively within the scope of his authority, if he exercises his corporate authority in order to benefit himself personally or a third person rather than the company, this constitutes an abuse of his authority, although the act at issue is nevertheless valid and enforceable against the company by third parties. However, in the event that the third party has acted in bad faith, the company may refuse to recognize the representative director's acts on the basis he has abused his authority. Based on this legal framework, the Supreme Court has held that, based on application by analogy of the rule of mental reservation (Civil Code Art. 93 proviso), where a third party knows or should reasonably know of there has been an abuse of authority, the representative director's act may not be asserted against the company (Supreme Court Judgment, 1963.9.5, *Minshu* 17.8.909).

**[C] The Consequence of Acts by a Representative Director Not Based on Board of Director Resolutions.** Acts by a representative director without passage of a required resolution authorizing the conduct by the board (or in the alternative, acts based on an invalid board resolution), are not necessarily invalid, and it is necessary to consider the company's interests that would be protected by requiring a resolution authorizing the act, and the interests of the third party that relied upon the understanding that the representative director was acting pursuant to a proper board decision (transactional security), and make a decision based upon a comparative balancing of the specific facts and circumstances. Regarding the particulars of internal corporate management issues such as the convening of a board meeting, there is no need to consider transactional security interests, and therefore the defect makes the act voidable (grounds of a resolution of cancellation at the general meeting of shareholders).

**[vi] Apparent Representative Directors.** Other than those directors appointed as representative directors, the board members of a stock company with a board of directors do not have the authority to represent the company in transactions with outsiders, and the names of the representative directors are a matter of public registration (Company Code Art. 911 Para. 3 Item 14). Therefore, a third party dealing with the company should be able to determine who has actual representative authority by looking at the company's registered information. However, where directors with titles such as *shacho* n9 or *fukushacho*, n10 which are generally acknowledged to be positions of representative authority, engage in external dealings, it is probable that third parties may reasonably make the mistake that such persons are representative directors. For this reason, the Company Code prescribes that a company cannot avoid responsibility for the dealings of a board member who holds the title of either *shacho* or *fukushacho* in relation to third parties, even if that person did not have the actual authority to represent the company (Apparent Representative Director or *hyoken daihyo torishimariyaku*; *see* Company Code, Art. 354).

For a company to be held responsible for the dealings of an apparent representative director: 1) the director must hold an executive position with a title that generally is understood to have authority to act as the company's representative; 2) it is the company that has conferred the title on the director who has acted as a apparent representative director (includes instances where the company silently acquiesces to a director's pretense to hold a title indicating the existence of representative authority); and 3) a good faith belief by the third party that the apparent representative director's authority actually existed. The Supreme Court has held that where the third party has negligently relied on apparent representative authority, this is considered to be the same as bad faith reliance and the company bears no responsibility in such an instance (Supreme Court Judgment, 1977.10.14, *Minshu* 31.6.825).

**[vii] Responsibilities of Directors**

**[A] Directors' Duty of Care Regarding Good Management and Duty of Loyalty.** The legal relationship between stock companies and their directors is governed by the rules of agency and delegated authority (Company Code, Art. 330); therefore, in their execution of job duties on behalf of their company, directors, the constituent members of boards of directors and representative directors all bear the duty of care to manage the company competently and in good faith regarding its interests (*zenkanchui gimu*; Civil Code, Art. 644). Also, directors must adhere to applicable statutory laws and the provisions of the articles and bylaws as well as resolutions adopted by the general meeting of shareholders, and in general bear the responsibility to execute their job duties loyally and faithfully to the company (*chujitsu gimu*; Company Code, Art. 355).

**[B] Director's Duty to Refrain from Competing with the Company.** Because a director has access to detailed knowledge regarding the company's trade secrets and other valuable, confidential information, in order for a director to engage in dealings for himself or a third party that are in competition with the company, he must disclose material facts relating to those activities at a general meeting of shareholders (for companies with board members, at a board meeting), and receive the company's consent to engage in the competitive activity (Company Code, Art. 356 Para. 1, Item 1, Art. 365, Para. 1).

For the purposes of this analysis, in addition to the business actually conducted by the company, business areas into which: 1) the company has decided to expand and has actually began preparations for entry; and 2) business that the company has previously engaged in and has merely temporarily suspended or ceased, are also considered to belong to the same category as the intended business dealings by a director and thus require company consent (Tokyo District Court Judgment, 1981.3.26, *Hanreiiho* 1015.27). "For oneself or a third party," for the purposes of this analysis, refers to acts that are performed by a director pursuant to the plans of the director or a third party, with the economic consequences of those acts being conferred upon the director or the third party.

**[C] Rules and Regulations Concerning Conflicts of Interest.** A director engaging in dealings with the company for the benefit of himself or a third party is required to obtain the consent of the shareholders at a general meeting of shareholders (for companies with a board of directors, from the board; *see* direct dealings, Company Code, Art. 356 Para. 1 Item 2). Also, in order for the company to be a guarantor for a director's debts, or to allow a transaction between the company and a third party in which the interests of the company and the director are in conflict, the consent of the shareholders (or the board, if applicable) is required (Company Code, Art. 356 Para. 1 Item 3). There is some scholarly dispute regarding whether acts by directors relating to bills should constitute dealings that require consent from the company, but the Supreme Court has ruled on this issue in the affirmative (Supreme Court Judgment, 1971.10.13, *Minshu* 25.7.900).

For the purposes of this analysis, "for oneself or a third party," is understood to mean legally in the name of oneself or a third party. The Supreme Court has held that if there consent is obtained at the all of shareholders, separate consent from the board of directors is not necessary (Supreme Court Judgment, 1974.9.26, *Minshu* 28.6.1306).

A juridical act performed by a director without first obtaining the required consent from the company is void as between the director and the company, but the company may assert the invalidity against third parties acting in bad faith

(Supreme Court Judgment, 1968.12.25, *Minshu* 22.13.3511).

**[viii] Compensation of Directors**

**[A] Procedure for Determination.** The Company Code provides that the compensation of directors is to be prescribed in the articles and bylaws or fixed according to a resolution passed at the general meeting of shareholders (Company Code, Art. 361). Where compensation is set pursuant to a shareholders' resolution, it is not necessary to reaffirm the terms of compensation at every subsequent meeting; once agreed upon, the terms of director compensation are considered to be in effect until modified by another resolution at the general meeting of shareholders. According to the Supreme Court, it is not necessary for shareholders to pass a resolution that sets the compensation of each director individually; instead, it is permissible for the shareholders to vote to approve an amount for the compensation of all the directors and delegate to the board the authority to make decisions regarding the allocation of that amount to each of the directors, or the shareholders may, without approving a fixed total amount, set an maximum expendable amount and delegate to the board the authority to prepare a budget for director compensation within that limit and to decide how to specifically compensate each of the directors (Supreme Court Judgment, 1985.3.26, *Hanreijiho* 1159, 150).

Additionally, for companies with board committees, compensation for directors and *shikkoyaku* is determined by the compensation committee, specifically for each director and *shikkoyaku* (Company Code, Art. 409).

**[B] Scope of Compensation.** The Company Code expressly provides that bonuses constitute a form of compensation for job performance, are subject to the rules and regulations relating to compensation, and thus are required to be approved by a passage of a resolution at the general meeting of shareholders (Company Code, Art. 361 Para. 1). However, regarding the compensation of directors who are also employed as department heads (*bucho*) and general managers of branch offices (*shitencho*), i.e., so-called employee-directors (*shiyonin-kenmu torishimariyaku*), it is not necessarily a violation of law to have the company shareholders decide upon their compensation only as to their roles as corporate directors (Supreme Court Judgment, 1985.3.26, *Hanreijiho* 1159.150).

Regarding the grant of retirement benefits to directors by companies, the Supreme Court has held that while the general meeting of shareholders may not pass a resolution unconditionally entrusting this decision to the board of directors, it is permissible for the shareholders to pass a resolution setting specific guidelines pursuant to which the board may decide upon the amount, payment period, and payment method of retirement benefits (Supreme Court Judgment, 1964.12.11, *Minshu* 18.10.2143). Additionally, a district court has held that where the shareholders have delegated the authority to set the specific amount of retirement benefits entirely to the board of directors, but the board has neglected to make a decision, this constitutes a negligent breach of duty pursuant to Company Code, Article 429, Paragraph 1 (the retiring director is the third party complainant in this situation) and the board is legally liable as against the retiring director (Tokyo District Court Judgment, 1994.12.20, *Hanrei-Times* 893.260).

**[C] Stock Option System.** Stock options, the right to acquire the stock of one's own company (*jisha kabu konyuken* or simply *stokku opushon*) are a form of performance-based compensation granted to the directors and employees of a company, giving the option right holder the right to either purchase treasury stock held by the company at a specified price (treasury stock method or *jikokabushiki hoshiki*), or in the alternative purchase newly issued stock from the company at a specified price (warrant method or *waranto hoshiki*).

The granting of stock options to corporate directors or employees means the company is essentially conferring new stock reservation rights as a form of no-cost capitalization issuance for the company. As such, the granting of stock options, like any issuance of corporate benefits, procedurally requires a special resolution of consent by the general meeting of shareholders; in seeking the resolution, the representative director is required to present to the shareholders the reasons why this issuance of corporate benefits is necessary (Company Code, Art. 238 *Paras. 1-3;* Art. 309 Para. 2 Item 6). "The restrictions regarding the exercise period for new stock reservation rights and issuance limits no longer apply"--this explanation is cited from the statutory language of the former company law.

As set forth therein, the current statutory scheme regarding stock options is not part of the same legal framework as the rules regarding corporate compensation that are set forth in Article 361. However, under the new company law, there is an increasing trend toward disagreeing with the above legal characterization, favoring the reasoning that because stock options are issued as counter-value for the director's performance of executive management duties, it is not a special, advantageous issuance of stock (*yuri hakko*) and may be approved by a board resolution, or decided at the general meeting of shareholders subject to the approval procedures applicable to decisions regarding director compensation.

**[D] Directors' Right to Demand Compensation.** The legal relationship between a company and its directors is defined by the civil law rules regarding delegation of authority (Company Code, Art. 330), and therefore absent a contractual agreement, directors cannot demand compensation from the company (Civil Code, Art. 648 Para. 1). For this reason, the legal nature of the right of directors to demand compensation due can pose a problem. Regarding this issue, the Supreme Court has held that "in a stock company, where the compensation of directors is prescribed in specific detail in the articles and bylaws, or determined according to a resolution of the general meeting of shareholders (including where the total compensation budget for directors has been approved by a shareholders' resolution, and the board of directors have set the terms of compensation for specific directors from this amount) those terms of compensation constitute a contract between the company and the director, and binds both sides as contracting parties, and if after this the general meeting of shareholders passes a resolution for the purpose of denying a director his prescribed compensation from the company, that director, to the extent he does not consent to the resolution, should be properly understood to retain the right to demand his compensation as was previously determined. This reasoning does not change even if there is a dramatic change in the nature of the director's job duties and those changes are claimed to be the basis for the shareholder's resolution discussed earlier." (Supreme Court Judgment, 1992.12.18, *Minshu* 46.9.3006).

**[ix] Directors' Responsibility Toward the Company and to Supervise Shareholders**

**[A] Directors' Responsibility to the Company.** The illegal distribution of retained capital earnings as dividends (Company Code, Art. 462): where there has been a distribution of corporate retained capital earnings (profits) as dividends in excess of the stock company's permissible amount of distribution (Company Code, Art. 461 Para. 1), the executive managing director in charge of the distribution, or director who proposed the distribution to the shareholders or board of directors, etc., to the company, are jointly and severally liable for compensatory damages corresponding to the payment of sums equal to the book value of the issued funds, etc., issued to the persons receiving the illegal dividends (Company Code, Art. 462 Para. 1). However, the above directors are not liable if they are able to prove that they did not fail to exercise due care in performing their job responsibilities (negligence liability, Company Code, Art. 462 Para. 2). If retained capital earnings are paid out in excess of the maximum permissible distributable amount, the responsible director(s) may not be released from liability if their conduct was wrongful, even if there is a resolution passed at the general meeting of shareholders consenting to their release (Company Code, Art. 462 Para. 3).

Improper giving of benefits (Company Code, Art. 120, *Paras. 4-5):* where a stock company has, in violation of the law, gave benefits (*rieki kyoyo*) n11 such as distribution of company assets to certain of its shareholders in exchange for those shareholders' cooperation in the exercise of their voting rights (Company Code, Art. 120 Para. 1), the directors or *shikkoyaku* participating in such an unlawful giving of benefits as proscribed by ordinance of the Ministry of Justice (*see* Rules relating to the Enforcement of the Company Code (Ministry of Justice Ordinance 12, 2006), Art. 21), are jointly and severally liable to the company to damages corresponding to the paid-out amounts. However, provided that they are able to prove that they did not fail to exercise due care in performing their job responsibilities, this rule may not necessarily be applied strictly (negligence liability, Company Code, Art. 120 Para. 4). However, regarding restitution of improperly distributed company assets, the responsible directors are strictly liable to the company for the amounts paid out, and they cannot be released from strict liability unless there is a resolution passed at the general meeting of shareholders consenting to the release (Company Code, Art. 120 Para. 5).

Competitive dealing (Company Code, Art. 423 Para. 1-2): In the event that a director engages in personal business

dealings in violation of the rules relating to competitive dealing by directors, etc., against their companies (Company Code, Art. 356 Para. 1; *see supra*, [5(7)(b)), this constitutes a breach of duty to the company by said director, who is liable for compensatory damages to the company (Company Code, Art. 423 Para. 1). The amount of compensatory damages is calculated according to the monetary benefit received by the director or a third party as a consequence of the dealings (Company Code, Art. 423 Para. 2).

Dealings creating a conflict of interest between the director and the company (Company Code, Art. 423 Para. 1; Para. 3): where the company incurs financial harm as a consequence of dealings by its directors that conflict with the interests of the company (*rieki sohan torihiki*), directors or *shikkoyaku* are deemed to have acted in dereliction of their duty to the company in the following instances (Company Code, Art. 423 Para. 3): 1) directors, etc., who have engaged in dealings conflicting with the company's interest; 2) directors, etc., who made the decision to have the company engage in the dealings at issue; and 3) directors who attended the board meeting and voted in favor of the resolution to approve the dealings at issue. Regarding the first category, directors, etc., who directly engaged in dealings for their own benefit are strictly liable for the damages resulting from their breach of duty to the company, and cannot be released from liability for their wrongful conduct, either in whole or in part (Company Code, Art. 428).

Additional derelictions of duty (Art. 423 Para. 1): where directors, etc., have neglected to diligently perform their duties (*ninmu ketai*), they bear legal responsibility for any economic injury suffered by the company as a consequence. Financial injury caused to a company as a result of its directors engaging in acts in violation of statutory law, or corporate bylaws, is an example of such conduct. Whether directors neglected to diligently perform their duties is based on the generally applicable standards for breach of duty, and thus directors are only liable if they have intentionally or negligently performed their duties (*kashitsu sekinin*). Also, regarding the applicable statutory law, directors are potentially liable not only pursuant to the specific provisions as set forth in Articles 120 and 355; rather, whether directors incur legal liability based on dereliction of duty also includes consideration of whether they have breached their generally applicable duties, to exercise careful judgment in making business decisions and to act faithfully and loyally to the company.

The Business judgment rule (*keiei handan no gensoku*): this legal principle states that courts should not intervene merely to second-guess, *ex post facto*, the rightness or wrongness of business decisions made by company directors unless there was actually a breach of legal duty. Therefore, if the economic injuries resulted from decisions based on the business judgment of the company's directors, exercised in a manner satisfying certain preconditions evidencing sincere and rational deliberation, this exercise of business judgment should not be questioned by the courts. According to recent lower court decisions, it appears there is a tendency to apply the following standard; that is, whether there was a breach of duty of care or breach of duty of loyalty by the directors depends upon whether or not the act at issue was, from the perspective of a businessperson of normal management ability, either a rational decision within the range of possible decisions, or cannot said to be clearly irrational, taking into consideration previous cases as concrete examples (Tokyo District Court Judgment, 2004.9.28, *Hanreiiho* 1886.111).

**[B] Mitigation of Directors' Liability (Company Code, Arts. 425-27).** In addition to the provisions relating to release from liability (Company Code, Art. 424), limited to cases of liability arising from Article 423, Paragraph 1 of the Company Code (liability due to negligent breach of duty), the Company Code contains provisions that, subject to predetermined specific requirements (shareholder's resolution, prescription in the articles and bylaws, etc.), also permit mitigation of directors' financial liability for amounts ranging from two to six times their annual corporate compensation. Also, outside directors may execute agreements limiting their liability with the company (up to twice the amount of their annual compensation) in accepting their positions.

**[C] Supervision of Shareholders Concerning Executive Management.**

**[I] Derivative Litigation.** Shareholders who have held their stock continuously for a minimum of six months (this minimum period may be shortened in the bylaws, and this requirement does not apply to non-public companies; *see*

Company Code, Art. 847 Para. 2) may, in writing or by some other method, give notice of their complaints against the company's promoter, director, auditor, etc., and demand the company take responsibility for their actions (or inaction). Also, such shareholders have the right to demand restitution where the company has improperly distributed assets or other benefits to shareholders in exchange for their votes in shareholders' meetings (Company Code, Art. 120, Para. 3), and also to demand restitution where persons have received either stock or new stock reservation warrants (*shinkabu yoyakuken*) at unfairly advantageous prices, etc., from the company (action to have held responsible, etc.). If the company fails to file an action upon its own volition within 60 days after the submission of such demands, the shareholders who made the demand may, personally on behalf of the company, file actions to hold responsible, etc. (Company Code, Art. 847, Para. 3). This is what is termed shareholder derivative litigation.

To prevent shareholders from filing abusive derivative actions, the court has, upon receipt of a petition from the defendant, the authority to issue an order that the plaintiff post a bond for an appropriate amount (Company Code, Art. 847 Para. 7); however, it is only proper for the court to issue such an order if the defendant company has persuaded the court of the likelihood that the complaint was filed in bad faith by the plaintiff (Company Code, Art. 847, Para. 8).

Where a shareholder prevails in his derivative action to hold the company responsible, etc., (this includes partial judgments in his favor) and the shareholder has either paid the necessary expenses for litigation of the action (excluding court costs) or still needs to pay legal fees to his lawyer or law firm, the shareholder can demand that the company pay, within a reasonable limit as determined by the court, his costs and legal fees (Company Code, Art. 852 Para. 1). Even if the shareholder loses the derivative action, excluding actions found to be brought in bad faith, said shareholder is not, as against the company, required to pay any compensation for losses incurred by the company resulting from the litigation (Company Code, Art. 852 Para. 2).

**[II] Enjoining the Unlawful Acts of Directors.** Where the directors of a stock company engage in acts outside the scope of the company's business purpose or otherwise violate statutory law or the provisions of the articles and bylaws, or where the danger that such conduct will occur is present and it is probable that the conduct will result in considerable economic injury for the company (for companies with auditors, or companies with board committees, the requirement is unrecoverable loss), shareholders who have held stock in the company continuously for a minimum of six months (this minimum period may be shortened in the articles of incorporation, and is not a condition for shareholders of a stock company that is not a public company) may, on behalf of the stock company, bring an action against the directors to enjoin the conduct at issue (Company Code, Art. 360).

Furthermore, the company law expressly recognizes the shareholder's right to seek an injunction against his company when he believes the company's issuance of stock offered by subscription or new stock reservation warrants is violating the applicable laws and regulations or articles of incorporation or improper (Company Code, Art. 210, 247).

**[x] Responsibilities of Directors to Third Parties**

**[A] Overview.** Article 429, Paragraph 1 of the Company Code provides that "officers, etc., are liable for the compensation of third parties injured by the bad faith or grossly negligent acts of those officers, etc., in the performance of their job duties."

Regarding the above, the Supreme Court has stated that: 1) the grounds for this form of liability are based upon the creation of a special responsibility in order to strengthen the protection of third parties; 2) the court recognizes the conflict between this type of liability and the general standard for determining liability that arises from illegal conduct; 3) this responsibility is (for the purpose of strengthening the protection of third parties) recognized either to assess direct or indirect liability; 4) to find bad faith or gross negligence, a finding of a dereliction of duty to the company by the director is sufficient; and 5) "third party" under this provision is not limited to company obligees, but also includes shareholders (Supreme Court Judgment, 1969.11.26, *Minshu* 23.11.2150).

**[B] Duty of Directors to Monitor Conduct.** The board of directors has the authority to monitor the executive

management acts of its directors and executives (Company Code, Art. 362 Para. 2 Item 2), and the exercise of this authority is not limited to matters brought before the board; rather, the board has the duty to detect and monitor executive conduct even if it is not specifically brought to its attention (Supreme Court Decision, 1973.5.22, *Minshu* 27.5.655). For directors of a stock company without a board of directors, each director vested with executive management authority has the duty to monitor the executive conduct of the other directors. The duty to monitor, while nominal in reality, also exists as to those persons who agreed to the appointment of the directors (Supreme Court Judgement, 1973.5.22, Minshu 27.5.655; Supreme Court Judgment, 1980.3.18, *Hanreijiho* 971.101).

**[C] Duty of Directors Named in the Corporate Registry Only.** By application by analogy of Article 908, Paragraph 2 of the Company Code that prescribes "those persons who intentionally or negligently register false matters may not assert the untruthfulness of those matters as a defense against bona fide third parties," the Supreme Court has held that persons who are not directors, but have allowed themselves to be registered as directors of stock companies, may not assert the fact that they are not really directors as a defense against bona fide third parties, and pursuant to Article 429, Paragraph 1, cannot avoid being held liable to those third parties (Supreme Court Judgment, 1972.6.15, *Minshu* 26.5.984). Thus, where grounds for the application by analogy of Article 908, Paragraph 2 exist, the person registered as a director is treated as having, either intentionally or negligently, agreed to being registered as a director.

**[D] Duty of Former Directors to Third Parties Prior to Registration of Resignation.** Where a director resigns but does not give notice of his resignation to the company representative responsible for filing for changes in the company's registered information, and furthermore there are special circumstances such as evidence that he has explicitly consented to leaving the corporate registry uncorrected, etc., the resigned director whose resignation is not recorded in the corporate registry is not, by application by analogy of Article 908 of the Company Code, entitled to assert the fact that he has resigned as a director of the company as a defense against bona fide third parties, and as a consequence may not avoid the liability of directors prescribed in Article 429, Paragraph 1 of the Act (Supreme Court Judgment, 1987.4.16, *Hanreijiho* 1248, 127). To impose this liability, it is necessary for the director to have explicitly consented to the company's failure to indicate his resignation in its registry.

**[xi] Accounting Counselors**

**[A] Overview.** The position of "accounting counselor" (*kaikei sanyo*) is an executive position newly established by the Company Code in 2005. Any stock company may, by inclusion of the required terms in the articles and bylaws, establish a corporate post of accounting counselor (Company Code, Art. 326 Para. 2). The hope is that accounting counselors, by preparing financial statements with the cooperation of directors and executive managers, will work to improve both the sufficiency and accuracy corporate financial documentation. In comparison to outside accounting auditors (*kaikei kansanin*, discussed *infra*), who are outside agents who audit financial statements after they are independently prepared by companies, accounting counselors are part of the company's internal organization and management and are responsible for the actual preparation of the financial statements of the companies that retain them.

Companies with accounting counselors that are not public stock companies are not required to appoint an auditor (*kansayaku*) (Company Code, Art. 327 Para. 2 proviso).

**[B] Qualifications and Appointment, Etc.** An accounting counselor must be a certified public accountant (*konin kaikeishi*), audit firm (*kansahojin*), tax accountant (*zeirishi*), or tax accounting firm (*zeirishihojin*) (Company Code, Art. 333, Para. 1). Generally speaking, an accounting counselor is appointed by the passage of an ordinary resolution at a general meeting of shareholders, and may be dismissed at any time (Company Code, Art. 329 Para. 1, Art. 339 Para. 1; regarding the necessary quorum *see* Art. 341). However, in the event that an accounting counselor is dismissed without just cause, he may demand compensatory damages from the company (Company Code, Art. 339 Para. 2).

Regarding an accounting counselor's term of appointment, the statutory end of a term is at the close of the final ordinary general meeting of shareholders that is held within the two-year period (for companies with board committees, one year) following the initial appointment of the accounting counselor; however, it is possible to shorten this period by

either prescribing it in the bylaws or by a resolution passed at the general meeting of shareholders (Company Code, Art. 332 Para. 1 Item 3, Art. 334 Para. 1). Regarding expiration of terms and the provision of compensation and/or expenses to accounting counselors, the Company Code contains provisions equivalent to those applicable to directors (Company Code, Art. 334 Para. 1, Art. 332, Art. 379,).

**[C] Duties.** Accounting counselors must, in addition to cooperating with the directors (in companies with board committees, *shikkoyaku*) in order to prepare the stock company's financial statements and supporting itemized statements, provisional financial statements and associated financial documentation, also prepare accounting counselor's reports (Company Code, Art. 374 Para. 1). Accounting counselors possess the right to access corporate books and accounting records, the right to review and copy documents, the right to demand reports concerning the accounts of subsidiary companies, and the right to investigate the condition of the company's operations and assets (Company Code, Art. 374 *Paras. 2-4*). Accounting counselors of companies with a board of directors are responsible for attending board meetings convened for the approval of corporate financial statements, and at such times as necessary, must give his opinions (Company Code, Art. 376, Para. 1). In matters relating to the preparation of financial documents, in the event that the accounting counselor's opinions are contradictory to the views of the directors (or executive managers), the accounting counselor may express his opinions regarding the matter at the general meeting of shareholders (Company Code, Art. 377). Accounting counselors also have the responsibility to provide explanations sought by shareholders regarding the company's financial statement at a general meeting of shareholders (Company Code, Art. 314). Furthermore, in the event that the accounting counselor discovers in the course of performing his duties that the directors or executive managers of the company have acted improperly or in violation of statutory law or provisions of the articles and bylaws, he must report his findings promptly and without delay to the shareholders (for companies with auditors, to the auditor; for companies with auditing boards, to the auditing board; for companies with board committees, to the auditing committee) (Company Code, Art. 375).

**[D] The Retention and Disclosure of Financial Statements, Etc.** An accounting counselor is, separate and distinct from the company, required to maintain a set of the company's financial statements for the most recent five-year period in a location of his own choosing (Company Code, Art. 378 Para. 1), and shareholders or company obligees may, during any time during the company's regular hours of operation, as against the accounting counselor, make a request to review those documents (Company Code, Art. 378, Para. 2).

**[E] Liability of Accounting Counselors.** As company officers, etc., accounting counselors who have neglected their job duties are personally liable for compensatory damages (Company Code, Art. 423 Para. 1). Further, accounting counselors are subject to the essentially the same rules regarding liability exposure to third parties, mitigation of personal liability, exposure to derivative litigation, etc., as outside directors as discussed *supra* (Company Code, Art. 425 Para. 1, Art. 429 *Paras. 1-2*, Art. 847).

**[f] The Statutory Auditor System**

**[i] Overview--Distinguishing the Rules for the Statutory Auditor System.** As prescribed by the Company Code, it is not necessary for small and medium-sized companies to have auditors (*kansayaku*, Company Code, Art. 326 Para. 2) under its statutory scheme. Companies with accounting counselors that are not public companies are also not required to retain *kansayaku* auditors (Company Code, Art. 327 Para. 2 proviso). In contrast, companies with a board of directors (excluding companies with board committees) are required to have statutory auditors (Company Code, Art. 327 Para. 2main clause). Companies with accounting auditors (*kaikei kansanin secchi kaisha*), excluding companies with board committees, are also required to have *kansayaku* auditors (Company Code Art 327, Para. 3). Stock companies that are not public companies (excluding companies with boards of auditors and companies with accounting auditors), may limit the auditing authority of their *kansayaku* auditors such that they have no greater authority than accounting auditors (Company Code, Art. 389, Para. 1). In addition, large companies (*daigaisha*, meaning stock company with either a capital amount of yen 500 million or greater, or a total obligation of yen 20 billion or greater) are required to have at least one *kansayaku* auditor as well as at least one accounting auditor (Company Code, Art. 328 Para. 1). Companies with boards of auditors, on the other hand, must have three or more *kansayaku* auditors, at least

half of whom must be outside auditors (Company Code, Art. 335 Para. 3); finally, for companies with boards of auditors, the audit committee is required to elect a full-time auditor (Company Code, Art. 390 Para. 3).

**[ii] Auditors**

**[A] The Significance of the Auditor Position.** Stock companies may, pursuant to the provisions of their articles and bylaws, retain one or more auditors (Company Code, Art. 326 Para. 2). The corporate function of auditors is to audit the corporate conduct of the directors (if the company has accounting counselors, also the accounting counselors) (Company Code, Art. 381, Para. 1). Where there are multiple auditors at one company and each of them are company officers, each auditor independently possesses all of the authority vested in the auditor position (independent authority system) by law. In general, an auditor has the authority to audit not only accounting matters, but operational matters of the company as well.

**[B] Status Within the Company.** The auditor is appointed by the company shareholders at a general meeting (Company Code, Art. 329 Para. 1). The election of the auditor is ratified by the passage of a resolution at an ordinary general meeting of shareholders; cumulative voting is not a recognized appointment method. In cases where a company auditor is in office, directors shall obtain the consent of the company auditor (or, in cases where there are two or more company auditors, the majority of the company auditors) in order to submit a proposal for the election of a company auditor to the shareholders meeting (Company Code, Art. 343, Para. 1), and the company auditor may request the directors that they include the election of the company auditor in the purpose of the shareholders meeting, or they submit a proposal regarding the election of company auditor to the shareholders meeting (Company Code, Art. 343, Para. 2). An auditor may attend the general meeting of shareholders and express opinions regarding his own appointment or dismissal (Company Code, Art. 345 Para. 4). In addition, there is also a statutory scheme regarding interim auditors (*hoketsu kansayaku*; *see* Company Code, Art. 329 Para. 2).

Regarding the qualifications required of auditors, as is the case with directors there are no particular requirements regarding certification, stockholder status, etc., and excluding companies that are not public companies, inserting provisions in the bylaws requiring auditors to stockholders in the company is not permitted; regarding grounds for disqualification, the same grounds (e.g., lack of capacity, not a natural person, etc.) that apply to directors also apply, according to statutory provisions pertaining to auditors (Company Code, Art. 335 Para. 1). Also, auditors may not, in addition to their positions as auditors, simultaneously be employed as directors, executives, or other employees of the company (Company Code, Art. 335, Para. 2).

Companies with boards of auditors must have three or more auditors, of whom half or more must be outside auditors (Company Code, Art. 335 Para. 3), but other types of companies do not have any such restrictions regarding the number of required auditors. The term of appointment for auditors is generally calculated such that it expires at the conclusion of the last regularly scheduled general meeting of shareholders taking place during the last fiscal year ending within four years of the initial date of appointment (Company Code, Art 336, Para. 1), but stock companies that are not public companies may, by prescribing the necessary terms in the articles of incorporation, extend the term to as long as ten years (Company Code, Art. 336, Para. 2). An auditor may be dismissed at a general meeting of shareholders at any time (Company Code, Art. 339 Para. 1); however, the dismissal of an auditor must be always be ratified through the special resolution process to be valid (Company Code, Art. 309 Para. 2 Item 7).

**[C] Job Duties and Authority**

**[I] Overview.** The auditor is the company official responsible for auditing the performance of executive business duties by the directors, as well as that of accounting counselors (Company Code, Art. 381 Para. 1), and as such his responsibilities are not limited to auditing the company's accounting, but extends to matters regarding company operations in general. Companies that are not public companies (excluding companies with auditors and companies with boards of auditors) may, however, limit the auditor's scope of authority to accounting-related matters (accounting auditor) by prescribing the necessary terms in the bylaws (Company Code Art. 383, Art. 2 Art. 389 Para. 1).

**[II] Specific Powers.** To articulate the specific powers of auditors more concretely, auditors at any time may, toward directors and accounting counselors as well as managers and other employees, request the preparation and submission of business reports regarding their activities, or conduct investigations into the situation of their companies regarding company operations and/or assets (Company Code, Art. 381 Para. 2). Furthermore, when it is necessary in order for an auditor to perform his job duties, the auditor may request business reports from a subsidiary of his company, or conduct an investigation regarding the situation of the subsidiary's operations and/or assets (Company Code, Art. 381 Para. 3). Also, auditors are required to attend general meetings of shareholders and express their opinions to the shareholders when it is necessary in the auditors' judgment to do so (Company Code, Art. 383 Para. 1). Also, where a director has engaged in improper conduct or the auditor recognizes there is a danger a director will engage in improper conduct, or the director is acting in violation of the law or the company's bylaws, or there are other extremely objectionable facts to be considered, the auditor must, promptly and without delay, report the situation to the other directors (for companies with a board of directors, to the board) to this effect (Company Code, Art. 382), and if necessary has the right to request that the board convene a board meeting (Company Code, Art. 383 Art. 2), or in the alternative call the board meeting himself (Company Code, Art. 383; Art. 2 Para. 3).

Finally, auditors may review the agenda items, etc., that directors intend to introduce at general meetings of shareholders, and where it is determined that an agenda item violates the law or the corporate bylaws, or otherwise contains extremely objectionable aspects, auditors must report these findings at the general meeting of shareholders (Company Code, Art. 384).

In the event that a company with auditors files a legal action against a director, or a director files a legal action against a company with auditors, the auditor will serve as the company's official representative in the resulting lawsuit (Company Code, Art. 386).

In addition to this, auditors are recognized as having the right to file claims or petitions on behalf of their companies against directors for various types of judicial relief (Company Code, Art. 511 Para. 1, Art. 828 Para. 2, Art. 831 Para. 1). For example, auditors have the right to seek court orders enjoining a director's unlawful acts (Company Code, Art. 385, Para. 1).

The results of an auditor's investigations regarding company matters are divulged in the investigative report that the auditor is required to prepare for each regular meeting of shareholders (Company Code, Art. 381 Para. 1).

**[E] The Relationship Between Companies and Auditors.** Rules and regulations applicable to corporate delegation of authority apply to the relationship between auditors and their companies, and therefore in performing their duties, auditors bear a duty of care to act in good faith in exercising their authority (Company Code, Art. at 330, Civil Code Art. 644). However, because the auditor position is not an executive management position, auditors are not bound by the duty of loyalty regarding their companies' business interests, and thus restrictions concerning the duty not to compete in business or to avoid conflicts of interest do not apply to auditors.

The compensation for auditors must be set separately from that of directors (Art. 387 Para. 1). Where the compensation is being determined by shareholders' resolution for two or more auditors, the terms of compensation for each of the auditors is decided after consultation between each of the auditors and the general meeting of shareholders (Art. 387a Para. 2).

**[F] Responsibilities of Auditors**

**[I] Responsibility to the Company.** Auditors who neglect their job duties are jointly and severally liable for paying compensatory damages for any economic injury suffered by the company due to their failure to perform their duties diligently (Company Code, Art. 423 Para. 1), and this responsibility can only be waived by the consent of the shareholders at a general meeting (Company Code, Art. 424). Certain types of contracts for partial or complete

exemption from liability are, however, permitted under the company law (Company Code, Arts. 425-427).

**[II] Responsibility to Third Parties.** Auditors who have acted in bad faith or in gross negligence in performing their job duties are jointly and severally liable to third parties for compensatory damages resulting from those acts (Company Code, Art. 429 Para. 1). If an auditor's report contains false information regarding an important, mandatory subject of the report, the auditor is responsible for proving his lack of negligence; if unable to do so, he is liable to any third persons who have suffered injury as a consequence of the false information (Company Code, Para. 2 Item 3).

**[G] Boards of Auditors.** Large companies (as defined by Company Code Art. 2 Item 6) are required to have a board of auditors, except for non-public companies and companies with board committees (Company Code, Art. 328, Para. 1). The board of auditors is responsible for performing company duties such as the preparation of audit reports (Company Accounting Regulations Art. 151, Ministry of Justice Ordinance No. 13, 2006), the selection and dismissal of full-time auditors, establishment of terms and conditions relating to the execution of job duties by auditors, and so on (Company Code, Art. 390 Para. 2).

The applicable procedural rules for convening board of auditors meetings, relating to the keeping of minutes, etc., for boards of auditors are not the same as those applicable to boards of directors (Company Code, Arts. 391-394). As a general condition, the passage of resolutions requires a simple majority of the appointed auditors (and not merely those in attendance at the meeting) to vote in favor of the resolution (Company Code, Art. 393 Para. 1). Regarding one matter only, the dismissal of an accounting auditor, unanimous assent of the auditors is required to pass the resolution (Company Code, Art. 340 Para. 2; Para. 4).

**[iii] Accounting Auditor.**

**[A] Corporate Status of the Accounting Auditor**

**[I] Qualifications.** An accounting auditor (*kaikei kansanin*) is required to be a certified public accountant (*konin kaikeishi*) or an auditing firm with juridical person status (Company Code, Art. 337 Para. 1). Also, to assure the fairness of the auditing, the Company Code prescribes certain grounds for disqualification of an accounting auditor, such as a person with significant interests in the company he is supposed to be auditing, etc. (Company Code, Art. 337 Para. 3).

**[II] Term of Engagement.** An accounting auditor's term of engagement expires at the closing of the final ordinary general meeting of shareholders that is held within one year of his date of engagement; however, in the interest of creating stability for the position, unless a specific resolution is passed at the aforementioned shareholders' meeting to terminate the accounting auditor, the accounting auditor's engagement is deemed to have been implicitly renewed for another term of the same period (Company Code, Art. 338 Para. 1; Para. 2).

**[III] Selection Process.** The selection of an accounting auditor is made according to the passage of a resolution at the general meeting of shareholders (Company Code, Art. 329 Para. 1). Where the directors intend to propose, as a submitted agenda item at the general meeting of shareholders, the appointment of a certain accounting auditor, it is necessary for the directors to first obtain the consent of the company's auditors. On the other hand, where it is the company's auditors who are independently proposing the appointment of an accounting auditor, the auditors have the right to take the proposal to the board of directors and request that a general meeting of shareholders be called for the purpose of having its proposed appointment decided as an agenda item (Company Code, Art. 344 Para. 1 Arts. 1-2).

**[IV] Dismissal.** At any time during their term of engagement, accounting counselors may be dismissed by their companies pursuant to the passage of a resolution at the general meeting of shareholders to that effect (Company Code, Art. 339 Para. 1); however, where it is the board of directors that has submitted the proposal to dismiss an accounting auditor to the shareholders, the proposal is not valid unless the company's auditors have given their approval regarding the dismissal (Company Code, Art. 344 Art. 1 Para. 2). In certain cases, it is possible for the company's auditors to dismiss an accounting auditor by unanimously voting for dismissal, but if dismissal is thus effectuated, the auditors

must present a report at the next general meeting of shareholders occurring after the dismissal and inform the shareholders of the dismissal, as well as the grounds upon which it was based (Company Code, Art. 340, Para. 1-4; regarding companies with board committees, *see* Para. 5). Where dismissal is decided by shareholder resolution and excluding instances where there are valid grounds for dismissal, the accounting auditor can demand compensatory damages from the company for the dismissal (Company Code, Art. 339 Para. 2), but may not seek such damages if it is the company's auditors who have effectuated the dismissal. Finally, an accounting auditor has the right to attend the general meeting of shareholders and express his opinion regarding the appointment, non-reappointment or dismissal of any of the company's accounting auditors, including but not limited to himself (Company Code, Art. 345 Para 1, Para. 5).

**[B] Accounting Auditors--Duties and Authority.** It is the responsibility of accounting auditors to audit the company's financial statements as well as any accompanying detailed statements, itemizations and connected financial documents, provisional financial statements (Company Code, Art. 396 Para. 1). For this reason, the accounting auditor has the right to review or copy the company's accounting books and other financial documents at any time, and request accounting-related reports from the company's directors, manager and other employees; if necessary for the performance of his job duties, he may also investigate the condition of the company's operations and assets and also has the authority to investigate subsidiary companies (Company Code, *id. Paras. 2-4).*

In carrying out job duties, if the accounting auditor learns that a director has either violated the law or the company's bylaws, or has otherwise engaged in improper conduct, the accounting auditor must report his findings to the company's auditors, or audit committee if applicable (Company Code, Art. 397 Para. 3; for companies with board committees *see id. Para. 4).*

**[C] Liability of Accounting Auditors.** An accounting auditor is liable to the company for compensatory damages in the event that the accounting auditor's failure to perform job duties causes economic injury to the company (Company Code, Art. 423 Para. 1). If the company does not pursue its rights to receive compensation from its accounting auditors, its stockholders have the right to bring a derivative lawsuit (Company Code, Arts. 847, 853). Regarding complete or partial release from liability or a limitation of liability by contractual agreement, the rules applicable to accounting auditors are essentially the same as the provisions applicable to directors, etc. (Company Code, Arts. 424, 427). As to third parties, accounting auditors are liable for compensatory damages where the economic injury to the third party was caused by his bad faith or grossly negligent acts in carrying out his duties, or in the alternative, where the injury was caused by the inclusion of a false statement or record in an auditing report regarding an important matter, and the accounting auditor is unable to affirmatively prove a lack of negligence in permitting the false statement or record to be included in the report (Company Code, Art. 429 Para. 1,; Para. 2, Item 4).

**[g] Special Exceptions Concerning Companies with Board Committees**

**[i] Special Case Concerning the Establishment of Systems of Corporate Governance.** The term "companies with board committees" (*iinkai secchi kaisha*) refers to those stock companies that, under the provisions of the Company Code, have three committees, the nominating committee, the audit committee, and the compensation committee, each with discrete corporate decision-making duties (Company Code, Art. 2 Item 12). Companies that intend to establish board committees must prescribe the necessary terms in their bylaws (Company Code, Art. 327 Para. 4). Companies with board committees do not have *kansayaku* auditors (*see* [6][a] *supra*); in their place, the three board committees listed above, each of which is comprised of three or more directors (in turn, at least half of the directors on each of the board committees must be outside directors) are established by the company (Company Code, Art. 400 Para. 1; Para. 3). In addition, a special executive manager called *shikkoyaku*, or in the alternative a representative executive manager called *daihyo-shikkoyaku*, is appointed by the board of directors, and is responsible for the performance of executive management duties, as well as any other matters expressly delegated by the board, for companies with board committees.

Finally, the term of engagement for directors of companies with board committees is one year (Company Code, Art.

332 Para. 3), along with which the board of directors may be granted the power to distribute retained capital earnings.

**[ii] Special Cases Concerning Boards of Directors and Directors**

**[A] The Authority of the Board of Directors.** The board of directors of a stock company with board committees is responsible for making certain corporate decisions as set forth in Article 416 Paragraph 1 Item 1 of the Company Code, including creating the basic guidelines for the management of the company, the relationship between the board and *shikkoyaku*, internal control systems, etc., and other executive business issues for a company with board committees, and oversee the work of directors and *shikkoyaku* (Company Code, Art. 416 Para. 1, Items 1-2). The board of directors of a company with board committees may not delegate these executive management duties to individual directors (Company Code, Art. 416 Para. 3).

Excluding those responsibilities prescribed in Article 416 Paragraph 4 of the Act such as matters relating to the approval of stock transfers, etc., of transfer-restricted stock, the decision to convene a general meeting of shareholders, the appointment and dismissal of the representative *shikkoyaku*, the decision to distribute midterm dividends, the board of directors can decide to delegate the management duties of a company with board committees to *shikkoyaku*.

**[B] Term of Engagement and Scope of Authority of Directors and *Shikkoyaku*.** The term of engagement for directors of a company with board committees is basically one year, expiring at the closing of the ordinary general meeting of shareholders for accounting term-related matters for the most recent fiscal year, and within one year of his date of engagement (Company Code, Art. 332 Para. 3); the term of engagement of the *shikkoyaku* is also one year subject to the same terms (Company Code, Art. 402 Para. 7). Directors of a company with board committees cannot be given authority to make executive decisions regarding the company's business operations (Company Code, Art. 415). Accordingly, the appointment of so-called manager-directors, such as executive-directors (*senmu torishimariyaku*), manager-directors (*jomu torishimariyaku*), and other directors who also hold executive management posts with their companies, is not prohibited.

**[iii] Board Committees**

**[A] Organization and Authority of Board Committees.** The scope of authority of each of the board committees are as set forth below (Company Code, Art. 404).

Nomination committees (*shimei iinkai*): responsible for making decisions regarding the proposed selection or dismissal of directors, and preparing and submitting proposals regarding such selection or dismissal to the general meeting of shareholders.

Audit committees (*kansa iinkai*): responsible for auditing the corporate management-related conduct of the company's executive managers, etc. (generally refers to directors and *shikkoyaku*; for companies with accounting counselors, also includes accounting counselors), preparing periodic audit reports based on auditing activities, and making substantive decisions regarding the proposed selection or dismissal of accounting auditors (*see* [6[c] *supra*) as well as submitting proposals to the general meeting of shareholders regarding the selection, dismissal, or non-renewal of accounting auditors. The auditing powers of audit committees are understood not to be limited to investigating the lawfulness of the conduct of executive managers, but also the propriety of such acts in relation to the company's best interests.

Compensation committees (*hoshu iinkai*): responsible for setting the specific compensatory terms for company officials such as directors, *shikkoyaku*, etc. The compensation committee has the authority to make final decisions regarding compensation for directors and *shikkoyaku*; they are not required to have their decisions approved by the shareholders at the general meeting.

**[B] Operation of the Committees.** Upon a request made by a board committee, *shikkoyaku*, etc., are required to attend the meeting of that board committee and provide explanations regarding the matters of concern to the board

committee (Company Code, Art. 411 Para. 3). Even when there is a specific director designated with the authority to convene full board meetings, each of the board committees may also confer upon one of members the right to order a full board meeting (Company Law, Art. 417 Para. 1). The board committee member who has called the board meeting pursuant to his appointment by the board committee is required, promptly and without delay, to report at the board meeting the operational situation of the board committee (Company Code, Para. 3).

**[C] The Audit Methods, etc. of Audit Committees.** Audit committees bear the responsibility of auditing the acts of the directors and *shikkoyaku* of the company and reporting them in the event they engage in violations of the law, company bylaws, or otherwise engage in improper conduct (Company Code, Art. 406). Audit committees possess the right to bring lawsuits on behalf of their companies and to seek court injunctions prohibiting the illegal acts, etc., of directors or *shikkoyaku* (Company Code, Art. 407). Members of the auditing committee have the right to hold hearings to question the company's *shikkoyaku*, etc., regarding their executive conduct and also have the authority to conduct investigations regarding the business operations and/or assets of the company as well as its subsidiaries (Company Code, Art. 405).

**[D] The Methods for Fixing Compensation, etc., by Compensation Committees**

Compensation committees are required to set guidelines relating to the decision-making methods for setting substantive, specific terms of compensation for the company's *shikkoyaku*, etc. (Company Code, Art. 409 Para. 1), and may not exercise their authority to make compensation decisions unless acting in compliance with those guidelines (Company Code, Para. 2).

**[iv] The *Shikkoyaku* and Representative *Shikkoyaku***

**[A] The Job Duties of the *Shikkoyaku*.** The job duties of the *shikkoyaku* are set forth below:

Decision-making authority delegated by the board of directors: the scope of a *shikkoyaku's* decision-making authority is limited to what the law prescribes as duties that must be vested in the *shikkoyaku* position, as well as those duties that the law allows the board of directors to delegate to the *shikkoyaku* (however, any authority belonging by default to the board that is not expressly delegated to the *shikkoyaku* is retained by the board). Specifically, this includes issuance of stock by subscription, disposal and retirement of company holdings of its own stock, stock splits, allocation of capital reserves, the issuance of new stock reservation warrants, etc.

Exercise of duties: the authority to make executive business decisions on behalf of companies with board committees is exclusively vested in the companies' *shikkoyaku*. While *shikkoyaku* possess all of the executive decision-making authority of their companies, they do not necessarily have the authority to act as their company's official representative, as that authority belongs specifically to *daihyo-shikkoyaku* (representative *shikkoyaku*).

**[B] Selection and Appointment of *Shikkoyaku*.** Companies with board committees must have one or more persons holding the title of *shikkoyaku* (Company Code, Art. 402 Para. 1). The selection, appointment and dismissal of *shikkoyaku*, etc., are decided by the board of directors (Company Code, Art. 402, Para. 2, Art. 403 Para. 1). The rules concerning the qualifications required of directors apply *mutatis mutandis* to *shikkoyaku* (Company Code, Art. 402 Para. 4). Companies may not pass bylaws requiring *shikkoyaku* to be shareholders (Company Code, Art. 402, Para. 5; however, this rule does not apply to companies with board committees that are not public companies, *see* Company Code, Art. 402 proviso to Para. 5).

The term of office for *shikkoyaku* is basically one year, officially expiring at the first board meeting after the company's ordinary general meeting of shareholders concerning accounting term-related matters for the most recently completed fiscal year, but in any instance within one year of the date of appointment (Company Code, Art. 402 Para. 7); it is possible for a director to also hold the position of *shikkoyaku* (Company Code, Art. 402, Para. 6)

**[C] Rights and Duties of *Shikkoyaku*.** The relationship between companies with board committees and their *shikkoyaku* is based on delegation of authority from the companies to their *shikkoyaku* (Company Code, Art. 402 Para. 3). *Shikkoyaku* have the duty to provide any explanations demanded by their company shareholders at the general meeting of shareholders (Company Code, Art. 314). In addition to this, the *shikkoyaku* has certain prescribed rights and duties, such as the duty to make periodic reports to the board committees (Company Code, Art. 417 Para. 4) and the right to call a meeting of the board of directors (Company Code, Art. 417 Para. 2).

**[D] Representative *Shikkoyaku*.** Companies with board committees are required by law to select and appoint one of its *shikkoyaku* as the company's official representative (*daihyo shikkoyaku*; Company Code, Art. 420 Para. 1). While there must be at least one representative *shikkoyaku*, the company may choose to designate more. The Company Code contains provisions concerning liability regarding apparent *shikkoyaku* analogous to those provisions concerning apparent representative directors (*see* [5[f]).

**[v] Registration.** Companies with board committees are required to register the company type (company with board committees) as well as the names of outside directors, the names of directors who are members of its various board committees, the names of *shikkoyaku* and the names and addresses of representative *shikkoyaku* (Company Code, Art. 911 Para. 3 Item 22).

**[h] New Stock Issuance**

**[i] Issuance of New Stock (Issuance of Stock by Subscription, Etc.)**

**[A] Statutory Scheme for Capital Authorization.** Under the Company Code, a stock company's articles and bylaws must state the total quantity of issuable stock in exchange for its capitalization, and public companies are required by law to issue at least one-fourth of the prescribed total quantity of stock at the time of incorporation (Company Code, Art. 37 Para. 1; Para. 3). As for the remaining quantity of the total issuable stock after this initial stock issuance, the board of directors may decide to issue quantities of the remainder as required to raise capital, without having to amend the bylaws (statutory scheme for capital authorization, Company Code, Arts. 199 and 201).

Issuance of new stock, like the initial issuance of stock at the time of incorporation, may be validly issued pursuant to an offering made by the company, even if the entire quantity of the intended stock issuance is not subscribed to and purchased; that is, it is permissible to issue only the stock that is actually subscribed to and purchased (Company Code, Art. 36 Para. 3, Art. 63 Para. 3, Art. 208 Para. 5).

Also, regarding the relationship between the total quantity of issuable stock as prescribed in the bylaws and the initial issuance of stock at the time of incorporation, the latter (the initial issuance) must be at least one-fourth of the total issuable stock (however, companies that are not public companies are not subject to this restriction; *see* Art. 37 Para. 3), and as this requirement must be complied with even after incorporation, even if the company subsequently increases its total quantity of issuable stock by amending its bylaws, the total issuable stock in any case cannot be greater than four times the outstanding issued stock at the time of incorporation (Company Code, Art. 113 Para. 3.

**[B] The Significance of the Issuance of New Stock.** New stock issuance (*shinkabu hakko*) refers to a company's issuance of new stock from its issuable stock reserves, which is the quantity of total issuable stock as set in the company's articles and bylaws less the amount of stock issued at the time of incorporation, and can refer to both the ordinary issuance of new stock and special issuance of new stock. The former is where the company's purpose in issuing stock is to obtain external financing for its capital demands, and the latter is engaged in for the capitalization of the company's own internal funds.

Generally, the term "new stock issuance" refers to the ordinary issuance of new stock, and the standard method is to invite potential investors by offering them the opportunity to subscribe to the stock issuance, in forms such as shareholder offerings (*kabunushi wariate*), third party offerings (*daisansha wariate*) and public offerings (*kobo*). In

shareholder offerings, the company offers a certain quantity of new stock to existing shareholders, with the allotment of purchasable shares being determined proportionately based on the individual shareholder's existing stock holdings (Company Code, Art. 202). Third party offerings are a method of corporate capital increase, where specific persons are invited to invest in the new stock issuance and become shareholders. In a public offering, potential investors are recruited at-large from the general public, and the company makes the determination to whom to allocate its issuance of new stock from among the applicants who respond to the offer.

Company law refers to the ordinary issuance of new stock as "issuance of stock by subscription" (*boshu kabushiki no hakko*) and such issuances are subject to the same types of rules as the retirement and disposal of existing stock.

**[ii] The Decision to Issue New Stock.** Whether a stock company is recruiting subscribers to a stock issuance or seeking to dispose of its own stock holdings, on all such occasions, the company must decide the five terms regarding the stock offering that are prescribed in Article 199, such as the quantity of stock, the type of stock, the price to be paid by the subscribers, and the method of calculating stock price (Company Code, Art. 199, Paragraph 1 Items 1-2), etc.

Regarding the quantity of stock that is offered, the quantity of the stock issuance cannot be in excess of the quantity of issuable stock, as prescribed in the company's articles and bylaws, that remains after the initial stock issuance at the time of incorporation. Also, "the stock price" refers to the money to be paid or the value of the non-monetary asset to be exchanged in return for one share of the stock for the purposes of the issuance, but in stock offerings to parties other than existing shareholders, in order not to injure the interests of existing shareholders, the purchase price must be objectively fair. However, if approved by an special resolution at the general meeting of shareholders, the company may issue an advantageous offering. (Company Code, Art. 200 Para. 1, Art. 309 Para. 2 Item 5). The terms governing company stock offerings, must be evenly applied to each subscription (Company Code, Art. 199 Para. 5).

In-kind contributions are acceptable for new stock issuances, and regarding the persons who are permitted to make in-kind contributions, there are no restrictions such as those that apply at the time of incorporation (Company Code, Art. 58, Para. 1; Art. 63, Para. 1). However, to prevent unfair in-kind contributions, as a general rule an exchange of stocks for an in-kind contribution must be reviewed by a court-appointed auditor (Company Code, Art. 207 Para. 1).

**[iii] Issuance of Stock to a Specified Party at an Advantageous Price.** Where the issuance of stock takes some form other than a shareholder offering, consideration for protecting the interests of the existing shareholders is necessary, therefore the Company Code requires that any proposed new stock issuance to a specified third party at an especially advantageous purchase price (*yuri hakko*) be approved by special resolution at the general meeting of shareholders (Company Code, Art. 199 Para. 2, Para. 3; Art. 201, Para. 1; Art. 309 Para. 2 Item 5). "Especially advantageous purchase price" means that compared to an objectively reasonable purchase price, the price at which the stock is being offered to a specified third party is extremely advantageous; regarding factors in adjudging whether a particular price is reasonable or not, a court should focus its inquiry on the prevailing price, as well as taking into account the ease of divesting or transferring the stock at issue (Supreme Court Judgment, 1975.4.8, *Minshu* 29.4.350).

In the case of a public company, where a proposed new stock issuance concerns a stock that is publicly traded, in order to set a fair market price it is sufficient for the board of directors to agree to an acceptable method for setting the purchase price (book building system, etc.), as it provides a standard for easily determining a fair purchase price at the time of the acquisition date (Company Code, Art. 201 Para. 2).

**[iv] Procedure for the Issuance of New Stock**

**[A] Stock Subscription and Subscription Method.** A stock company, concerning persons seeking to subscribe to its offering of new stock, must provide such persons with notification containing information such as the company's business name, detailed terms of the new stock offering, the instrumentality processing payment for stock purchases, etc. (Company Code, Art. 203 Para. 1). Application for the purchase of new stock pursuant to a subscription offer is effectuated when the prospective subscriber submits a stock subscription application form to the company (Company

Code, Art. 203 Para. 2).

**[B] Allocation of Stock.** A stock company is required to determine from among the subscription applicants those who will be selected to participate in the new stock issuance, and also to determine the quantity of stock that will be allocated to each of the participants (Company Code, Art. 204.) If the stock being offered is transfer-restricted stock, a resolution from the general meeting of shareholders (for companies with a board of directors, the board of directors) approving the stock issuance is necessary (Company Code, Art. 204, Para. 2). Applicants receiving allocations of the issued stock are deemed to have exercised their rights to become shareholders and are legally responsible to pay for their stock acquisition (Company Code, Arts. 206 and 208). There are, however, legal provisions relating to invalidation or cancellation of certain exercises of rights (Company Code, Art. 211 Para. 2).

**[C] Inspection of In-Kind Contributions.** The provisions of company law relating to in-kind contributions generally come into effect at the time the terms and conditions of a stock subscription offering are agreed upon by the company (Company Code, Art. 199 Para. 1), but because the adequacy of corporate capitalization can be impaired in the event that in-kind contributions are improperly overvalued for some reason, the Company Code requires companies exchanging stock for in-kind contributions at the time of incorporation to have the exchange reviewed by a judicially appointed auditor (Company Code, Art. 207). On the other hand, where the initial in-kind contribution is a debt equity swap and the value of the stock is in excess of the outstanding debt amount, there is no need for the auditor to review the transaction.

**[D] Notice of Terms for New Stock Issuance.** In order to allow its stockholders the fair opportunity to sue for a court injunction against the stock issuance, a company issuing new stock is required to either publicly announce the terms of the stock issuance, or send notice of the new stock issuance to their stockholders directly, disclosing its terms and conditions, at least two weeks prior to the date upon which payment for the stock issuance becomes due (Company Code, Art. 201, *Paras. 3-4).*

**[E] Execution of Capital Investment.** On a date or during the requisite period of time as established in the terms and conditions of the stock issuance, those who have exercised their right to participate in the stock issuance are required to tender for payment to the company either the entire amount of the stock purchase price, or else perform the transfer of in-kind contributions for the stock (Company Code, Art. 208).

Once the required payment or provision of in-kind contributions has been tendered by the stock payment date, as prescribed in the terms and conditions of the stock issuance, the right to receive new stock arises as of the stock payment date, and the subscriber becomes a stockholder (Company Code, Art. 209, Item 1). If there is a period of time during which the payment may be made, the subscriber is given stockholder status on the same day that he tenders payment or makes an in-kind contribution in satisfaction of his stock payment obligations, rather than at the termination of the entire prescribed period (Company Code, Art. 209, Item 2). Where the subscription orders and/or the stock payments tendered to the company do not account for all the new stock that the company made available for issuance in its offering, rights to the new stock that were subscribed to and paid for are nevertheless valid, and the company is required to issue that stock to the subscribers (*uchikiri hakko*, reduced issuance).

**[v] Responsibility of Directors to Indemnify the Company for Insufficient Sums.** Where the actual value of an asset accepted as an in-kind contribution in exchange for stock, as appraised at the time of the new stock issuance, is considerably below the value that is required from an in-kind contribution for that quantity of stock (as prescribed in the terms and conditions of the stock issuance by the general meeting of shareholders or the board of directors), the executive managing director (for companies with board committees, the *shikkoyaku*) who carried out the transaction at issue in the stock offering; other corporate officials who participated in carrying out the transaction with the aforementioned executive managing director in charge; and the directors, etc., responsible for submitting the agenda item regarding the valuation of the in-kind contribution at issue to the general meeting of shareholders (for companies with a board of directors, to the board) in order to obtain a shareholders' resolution approving the in-kind contribution, are all jointly and severally liable to the company to pay the difference between the valuation accepted by the

shareholders (or the board) and the actual value of the asset at the time of new stock issuance (Company Code, Art. 213, Para. 1). However, if the valuation of the asset received as an in-kind contribution was performed by a court-appointed auditor and the responsible directors, etc., can show that they did not fail to exercise care in performing their official duties, the directors, etc., are not liable to the company (Company Code, Art. 213, Para. 2).

**[vi] Protective Measures Against Improper New Stock Issuances**

**[A] Injunctions Against New Stock Issuances (Petition to Prevent Stock Subscription).** Where a company engages in a new stock issuance or the disposal of its own stock in a manner that either violates statutory law or its own bylaws, or employs means that are considerably unjust, and furthermore there is a danger that the stockholders of the company will be harmed as a result of this conduct, a stockholder may bring an action for injunctive relief against the company seeking to judicially prevent the stock issuance or disposal at issue (Company Code, Art. 210). Examples of company conduct relating to stock issuance or disposal in violation of statutory law or the company's bylaws include issuing stock to a third party at an especially advantageous price without undergoing the procedure of obtaining a special resolution from the shareholders, as well as conducting a stock issuance without regard to subscription warrant rights of shareholders prescribed by the company bylaws. "Considerably unjust" means of issuing stock also broadly refers to stock issuances that are intended to achieve some improper corporate purpose. For example, there is a lower court decision that where a shareholder attempted to assert his influence on the company by buying up stock, it was considerably unjust for the directors to, as a countermeasure, attempt to issue a large quantity of stock to themselves or to a third party for the purpose of strengthening or preserving their control at shareholders' general meetings, even if the price paid for the stock issued for this purpose was otherwise reasonable (Tokyo District Court Judgment, 1989.7.25, *Hanreijiho* 1317.28).

**[B] Liability of Persons Acquiring Stock for Unfair Prices.** Persons who acquire stock by taking advantage of unfairly advantageous pricing offered to them by directors are liable to the company to pay the difference between the amount they paid for the stock, and the amount they should have paid based on a fair price (Company Code, Art. 212, Para. 1, Item 1). Representative actions by shareholders are recognized as a proper method for the attribution and enforcement of such responsibilities (Company Code, Art. 847).

**[vii] Invalidation of Stock Issuances.**

The Company Code, while permitting actions to invalidate stock issuances, seeks to restrict assertions of invalidity to the extent it is practicable, and even where a stock issuance is invalidated by judicial order, the law prescribes measures to determine invalidation in an evenhanded manner and to prevent the invalidation from having any retroactive effect (Company Code, Art. 828 Para. 1 Art. 2, Art. 839, Art. 840, Art. 841).

**[A] Grounds for Invalidation.** The company law does not prescribe particular grounds for invalidating a stock issuance and as a consequence, in order to determine if grounds for invalidation exist, it is necessary to consider the specific facts of each case to determine whether there has been non-compliance with the regulations of the applicable statutory law and corporate articles and bylaws, such that the stock issuance was defectively conducted in various impermissible ways. The company law supports the general principle of allowing invalidation actions as a protective measure to bring security to new stock issuances as a transactional method, and the issuance of new stock in a quantity that exceeds the maximum quantity of stock issuable by the company as prescribed in its articles and bylaws, as well as the issuance of specified stock of a type that is not prescribed in the bylaws, are generally accepted as grounds for invalidating a stock issuance.

Regarding a stock issuance made in contravention of a standing preliminary injunction granted pursuant to a prior action seeking to enjoin the stock issuance, the Supreme Court has held that if violating the preliminary injunction did not have any effect on the validity of the subsequent stock issuance, that would be disregarding the law's recognition of the right of stockholders to seek injunctions against improper stock issuances, was specifically contrary to the judicial purpose for granting preliminary injunctions to stockholders in such actions, and undermined the judicial objective of

assuring the effectiveness of the permanent injunction as a remedy, and for these reasons, adjudged that the stock issuance in violation of the preliminary injunction was invalid (Supreme Court Judgment, 1993.12.16, *Minshu* 47.10.5423). Also, the Supreme Court has held that where a stock issuance was conducted without the company giving public notice (Company Code, Art. 201 *Paras. 1, 3, and 4)* regarding the details of the stock issuance, the failure to give public notice may constitute grounds for invalidating a stock issuance, excepting cases in which the court specifically determines that even if the claim for an injunction is heard, the facts make it unlikely that adequate grounds for enjoining the company's stock issuance will be found (Supreme Court Judgment, 1997.1.28, *Minshu* 51.1.71).

In contrast, there is also a decision in which the Supreme Court ruled that where a stock issuance was conducted without going through the process of approval by the board of directors or at the general meeting of shareholders, and instead the issuance was made solely based on the judgment of the company's executive management, obtaining a resolution of approval from the board of directors or the general meeting of shareholders was nothing more than an issue of management decision-making internal to the company, and thus the stock issuance was valid (Supreme Court Judgment, 1971.7.16, *Hanreijiho* 641.97).

**[B] Actions to Invalidate Stock Issuances.** The invalidation of a stock issuances, in order to protect the security and stability of such transactions, may only be sought through litigation, and the company law (Company Code, Art. 828) restricts the applicable prescriptive period (within six months of the stock issuance generally, within one year for companies that are not public companies; Company Code, Art. 828, Para. 1 Item 2) and places limitations regarding who has standing to sue (stockholder, director, liquidator, auditor, *shikkoyaku*, Company Code, Art. 828, Para. 2, Item 2). A judgment of invalidity is enforceable as against the world (Company Code, Art. 838), and once final judgment of the invalidation is obtained, the stock at issue is without legal validity thereafter (Company Code, Art. 839).

**[C] Non-Occurrence of Stock Issuance.** Regarding actions to establish that a purported stock issuance never occurred at all, express statutory provisions have been prescribed that permit the bringing of such actions to establish the non-occurrence of an issuance of stock, disposal of a company's holdings of its own stock, and issuance of new stock subscription warrants that occur subsequent to the incorporation of the company (Company Code, Art. 829). There are no express statutory provisions that prescribe which persons have standing to sue, nor are there provisions regarding any applicable statute of limitations for bringing an action to prove the non-occurrence of a stock issuance.

**[viii] New Stock Reservation Rights**

**[A] Overview.** New stock reservation rights (*shinkabu yoyakuken*) refer to rights possessed by holders of new stock reservation rights (*shinkabu yoyakukensha*) that, when exercised against the company, requires the company to issue new stock to the rights holder, or in the alternative, transfer existing corporate holdings of its own stock to the rights holder to satisfy the demand.

Ordinarily, the exercise of a new stock reservation right is effectuated by the payment of a certain predetermined amount (exercise amount) within a preliminarily arranged, specified period (exercise period). Also, while it is standard practice for new stock reservation rights to be issued for a price corresponding to their value (i.e., in exchange for money or other assets), it is permissible for companies to grant new stock reservation rights without requiring such remuneration (however, this constitutes preferential treatment).

**[B] Procedure for Issuing New Stock Reservation Rights.** Upon passage of a resolution by the shareholders at their general meeting granting the necessary authority to the directors, and determination of the necessary terms as designated by law by the board of directors, a stock company may issue new stock reservation rights (Company Code, Art. 239). In the case of a public company, however, instead of the shareholders' general meeting, the board of directors grants such authority to the directors (Company Code, Art. 240 Para. 1). In order to issue new stock reservation rights to third parties pursuant to especially advantageous terms, it is also necessary for the directors to obtain the consent of the shareholders regarding the necessary terms as designated by law and the minimum issuance price for each type of stock (when granted with requiring payment, that should be indicated) by special resolution, and in requesting the passage of

the special resolution at issue, the representative director must attend the general meeting of shareholders and explain the reason the company needs to make the advantageous issuance to the third party (Company Code, Art. 238 Para. 3). Finally, while it is thought by some that the provision of stock options to company employees or directors must also follow the procedure for the approval of new stock warrants issued without consideration, there are some dissenting viewpoints regarding this issue.

**[C] Assignment of New Stock Reservation Rights.** As a general rule, new stock reservation rights may be transferred without special restrictions (Company Code, Art. 254 Para. 1). However, if the acquirer of the new stock reservation rights fails to have his name and address entered into the company registry recording outstanding new stock reservation rights, the acquirer may not assert his rights arising from the transfer against the company or any other third parties to the transfer (Company Code, Art. 257, Para. 1).

**[D] Retirement of New Stock Reservation Rights.** Stock companies can retire new stock reservation rights in their possession, and in that event are required to indicate the nature and quantity of the new stock reservation rights that are being retired (Company Code, Art. 276, Para. 1). Companies with a board of directors are required to formally establish this decision by the passage of a board resolution (Company Code, Art. 276, Para. 2).

**[E] Exercise of New Stock Reservation Rights.** An exercise of a new stock reservation right must clearly state the type and quantity of the new stock that is being requested, and the date of exercise (Company Code, Art. 280 Para. 1). Where the exercise price is predetermined, the payment of the required amount should also be made with the request (Company Code, Art. 281). On the date upon which the new stock reservation right has been exercised, the exerciser of the new stock reservation right becomes the holder of the stocks that are the subject of the reservation right (Company Code, Art. 282).

**[F] Invalidation of New Stock Reservation Rights.** As with new stock issuances, new stock reservation rights are subject to actions for invalidation (Company Code, Art. 828 Para. 1 Item 4) and actions to confirm non-occurrence of issuance (Company Code, Art. 829 Item 3) under the law. Provisions regarding standing to sue (Company Code, Art. 828 Para. 2 Item 4), the applicable prescriptive period (Company Code, Art. 828, Para. 1 Item 4), defendants (Company Code, Art. 834, Item 4), and the effectiveness of judgments (Company Code, Arts. 838, 839, 842) correspond to the terms for new stock issuances.

**[i] Corporate Debt Instruments**

**[i] Overview.** Corporate bonds and debentures, etc. (collectively debt instruments) refers to the practice of raising corporate capital from the general public and other private sources by segmenting company debt obligations into many small units, with repayment made in accordance with the provisions set forth in Article 676 of the Company Code. Corporate debt instruments are classified as a type of negotiable security. However, it is not always necessary to issue debt instrument papers. For example, the validity of publicly traded corporate debt instruments is verified electronically, pursuant to the Act for the Transfer of Debt Instruments and Stocks, etc.

Corporate debt instruments, depending on their subject matter, are categorized into common debt instruments (*futsu shasai*) and special debt instruments (*tokushu no shasai*), the latter having special attached rights such as new stock warrants, etc.; also, based upon whether or not there is property against which the debt at issue has been secured, debt instruments can be further categorized as secured debt instruments (*tanpotsuki shasai*) or unsecured debt instruments (*mutanpo shasai*), and depending on whether the name of debt holder is recorded on the face of the debt instrument certificate, as registered (*kimei shasai*) or bearer (*mukimei shasai*) debt instruments, and depending on whether or not the debt instruments are registered with the proper agency under the Securities Registration Act, book-entry (*torokusai*) and spot (*genbutsusai*) debt instruments.

**[ii] Procedure for Issuing Debt Instruments**

**[A] Decision for Issuance.** For companies with a board of directors, a resolution by the board of directors is needed to issue debt instruments (Company Code, Art. 362, Para. 4, Item 5), although the specific details, such as the amount, etc., may be delegated to the representative director. For companies with board committees, the decision is delegated to the shikkoyaku (Company Code, Art. 416 Para. 4). The resolution by the board of directors must make determinations regarding the total quantity of the debt instruments to be issued and required details such as the amount of debt to be issued, interest rate, repayment method, etc. (Company Code, Para. 4 Item 5, Art. 676 Para. 1; *see also* Regulations Concerning the Application of the Company Code (Ministry of Law Ordinance No. 12, 2006), Art. 162).

**[B] Methods of Issuance.** There are two methods for the issuance of debt instruments, in a private undertaking for the total amount (*sogaku hikiuke*) and by public offering (Company Code, Art. 677). In the *sogaku hikiuke* method, a specific party enters into a contract with the company issuing the debt instruments to pay the entire amount that the company seeks to raise in the debt instrument offering, in exchange for acquiring of all of the debt instruments. The law generally requires the party financing this method of debt issuance to be a trader in the financial products industry, such as a securities brokerage firm, etc. (*see* Financial Products Trading Act, Art. 2, Para. 6, Para. 8 Item 6, 9,). In public offerings, the company directly solicits to the general public in seeking subscriptions to the debt instrument offering, and the issuing company provides parties expressing interest with the specific terms (Company Code, Art. 677 Para. 1; see also Regulations Concerning the Application of the Company Code, Art. 163), and those parties then may apply to subscribe to the debt issuance by submitting applications stating their name, address, and amount or quantity of debt instruments to be purchased, etc. (Company Code, Art. 677 Para. 2).

**[iii] Management of the Debt Instrument Issuance**

**[A] The Debt Indenture Trustee.**

Where debt instruments are issued pursuant to a public offering, a debt indenture trustee (*shasai kanrinin*) must be designated by the company (Company Code, Art. 702). Those qualified to serve as debt indenture trustees are restricted by law to banks, trust companies and companies acting pursuant to those companies' businesses (Company Code, Art. 703; *see also* Regulations Concerning the Application of the Company Code, Art. 170). Once the position is accepted, the debt indenture trustees may not voluntarily resign, nor is the company permitted to unilaterally dismiss the debt indenture trustee thereafter (Company Code, Arts. 711 and 713).

**[I] The authority of the debt indenture trustee.** The debt indenture trustee has the authority to audit the management of the debt instruments subsequent to their issuance in order to protect the interests of the instrument holders, and also to engage in any and all acts (in litigation and otherwise) that are required to protect the security of the debt instruments (Company Code, Art. 705). Acts such as disposal of the debt instruments are carried out by the debt indenture trustee according to a resolution passed at the meeting of debt instrument holders (Company Code, Art. 706). The debt indenture trustee may have the right to investigate the business affairs and assets of the company (Company Code, Art. 705 Para. 4, Art. 706 Para. 4), to call a meeting of the debt instrument holders (Company Code, Art. 717 Para. 2), to attend the meeting and express its opinions (Company Code, Art. 729), and execute resolutions passed at the meeting (Company Code, Art. 737). Where the payment or settlement of debt by the issuing company to one segment of debt instrument holders is considerably unfair, the debt indenture trustee may bring a lawsuit seeking the cancellation of the disputed conduct (Company Code, Art. 865). If there are multiple debt indenture trustees, acts pursuant to their authority must be engaged in cooperatively by all the trustees (Company Code, Art. 709).

**[II] Duty of the debt indenture trustee.** The debt indenture trustee bears the duty to manage the interests of the debt instrument holders fairly and a duty to manage those interests in good faith (Company Code, Art. 704). The duty of fair management means that the debt indenture trustee has the duty to treat all of the numerous debt instrument holders impartially, and the duty of good faith means that the trustee, where the interests of the issuing company and the debt instrument holders are in conflict, has the duty to make its best efforts to act in the interests of the debt instrument holders, and not in the interests of the issuing company even though it is the contractual party of the trustee.

**[III] Liability of the debt indenture trustee.** Should the debt indenture trustee violate the provisions of company law or a resolution passed at the general meeting of its debt instrument holders, causing economic injury to the debt instrument holders, the debt indenture trustee is liable for the payment of compensatory damages (Company Code, Art. 710, Para. 1). Although the debt indenture trustee and the debt instrument holders are not bound by contract, liability exists due to special provisions under the company law established for the protection of debt instrument holders.

**[iv] Debt Instrument Holders' Meetings.** Debt instrument holders' meetings (*shasaikensha shukai*) are meetings of the decision-making body that passes resolutions regarding matters with an important relationship to the collective interests of the debt instrument holders, the composition of which is organized according to the types of debt instruments held by its members (Company Code, Art. 715). The meeting of debt instrument holders exists outside the company and is not a decision-making body of the company. The meeting of debt instrument holders may meet to pass resolutions regarding any matters that relate to the interests of the debt instrument holders, in addition to specific matters as set forth in the Company Code (Company Code, Art. 716). The right to convene meetings is held by the issuing company as well as the debt indenture trustee (Company Code, Art. 717 Para. 2), and debt instrument holders whose holdings constitute ten percent or more of the total financed debt amount also have the right to call meetings (Company Code, Art. 718 Para. 1).

Debt instrument holders may, at each of the meetings, cast votes corresponding to the total value of their holdings (excluding redeemed amounts) in relation to the total amount of the debt issued under the same category of debt instrument (Company Code, Art. 723 Para. 1). It is also permissible to exercise voting rights discretely (i.e., cast some votes in favor of some resolutions and others in opposition; *see* Company Code, Art. 728).

Generally, the method for making decisions is by ordinary resolution, the passage of which requires a simple majority of the attendees to vote in its favor (Company Code, Art. 724 Para. 1), but regarding matters of significant importance, a resolution must be approved by at least two-thirds of the attendees, who in turn must be holders of debt instruments accounting for at least one-fifth of the issued debt amount (Company Code, Art. 724, Para. 2).

Whether by ordinary or extraordinary resolution, judicial approval is required to make the resolution valid, and once judicially approved the resolution is binding on all of the debt instrument holders (Company Code, Art. 734).

There are no statutory provisions regarding legal actions to cancel resolutions made at a meeting of debt instrument holders or for the invalidation or confirmation of nonexistence of such resolutions.

**[v] Duty of Companies Issuing Debt Instruments**

**[A] The Creation of a Debt Instrument Registry and Issuance of Debt Instrument Certificates.** Companies issuing debt instruments must create a debt instrument registry recording each such issuance. A debt instrument registry must record the total amount of debt issued under each type of debt instrument and the total amount of capital that was received by the company in the issuance; additionally, for registered debt instruments, information such as the names and addresses of the debt instrument holders, and for bearer debt instruments, the quantity and serial numbers thereto, etc., are required (Company Code, Art. 681). The issuing company must keep and maintain the debt instrument registry at the principal office of the company (Company Code, Art. 684), and debt instrument holders, etc., may request to review or photocopy the registry at any time during the office's regular hours of business (Company Code, Art. 648 Para. 2).

**[B] Interest Payment and Redemption.** At regular prescribed intervals, debt instrument holders receive interest payments from the issuing company. For companies with a board of directors, the applicable interest rate, interest payment period and interest payment method are necessary prerequisite terms for issuing debt instruments to be determined by the board (Company Code, Art. 362, Para. 4, Item 5).

In the event the issuing company neglects to make interest payments, the debt interest holders can convene a meeting

and pass a resolution to notify the company that if the required interest payments are not made within the period set by the resolution (in any instance, that period being not less than two months), the debt instrument holders may elect to rescind the terms for debt maturity, and demand immediate repayment of the entire principal amount upon expiration of the specified grace period as set by the resolution (Company Code, Art. 739 Para. 1).

At the time of redemption (*shokan*), the general rule is for the company to repay the amount specified on the face of the certificate of the debt instrument, with the debt indenture trustee collecting the redemption amount for all of the outstanding debt instruments in one lump sum from the issuing company and, upon notification and public advertisement to the debt instrument holders, issue redemption payments in exchange for the debt instruments (Company Code, Art. 705). Where the issuing company has engaged in considerably unfair acts directed toward its debt instrument holders, the debt indenture trustee may bring an action seeking invalidation of the acts (Company Code, Art. 865).

**[vi] Special Debt Instruments**

**[A] Secured Debt Instruments (*tanpo tsuki shasai*).** Secured debt instruments are those debt instruments for which the rights to receive principal and interest are secured by physical assets, and are governed by the specific provisions of the Secured Debt Instruments Act (Law No. 52, 1905).

**[B] Debt Instruments with New Stock Reservation Rights Attached.** Debt instruments with new stock reservation rights attached (*shinkabu yoyakuken tsuki shasaiken*) are, as the name indicates, debt instruments to which new stock reservation rights are attached (Company Law, Art. 2 Item 22), and excluding those instances where the rights contained in the new stock reservation rights or the debt instrument are extinguished, it is not possible to sever and transfer only one of the two interests (Company Code, Art. 254 Para. 2 Item 3).

Under the Company Code, debt instruments with new stock reservation rights are subject to unique rules and regulations (Company Code, Art. 118 Para. 2, Art. 119 Para. 7, Art. 236 Para. 2, Art. 242 Para. 6, Art. 248, Art. 254 *Paras. 2-3,* Art. 255 Para. 2, Art. 258 *Paras. 3-4,* Art. 267 *Paras. 2-3,* Art. 268 Para. 3, Art. 272 Para. 4, Art. 280 *Paras. 3-5* and Art. 292; *see also* Art. 248).

**[j] Corporate Accounting**

**[i] Accounting Procedure.** Stock companies are required, on a regular and timely basis as designated by the Ministry of Justice, to prepare thorough and accurate records of their corporate accounting books (Company Code, Art. 432 Para. 1) and are also required to maintain those records for ten years after the accounts have been closed (Company Code, Para. 2).

Based on its corporate accounting books, a stock company is required to prepare a financial statement (balance sheet, profit and loss statement, other statements and explanatory charts indicating changes in the company's assets, shareholders' equity, etc.) for each fiscal year as well as periodic business reports and associated detailed statements (Company Code, Art. 435 Para. 2, Corporate Accounting Regulations, Art. 91 Para. 1).

For companies with auditors (*kansayaku*), the above-referenced documents must be audited by the auditor (Company Code, Art. 436 Para. 1). Also, for companies with accounting auditors (*kaikei kansanin*) it is necessary that the financial statements be audited by the auditor (for companies with board committees, the audit committee) as well as the accounting auditor, and auditing of the business report and the associated detailed statements by the auditor (or audit committee) is also necessary (Company Code, Art 435, Para. 2). Additionally, for companies with a board of directors, the above documents must be submitted to its shareholders prior to the ordinary general meeting of shareholders, for review and approval (Company Code, Art. 437).

All stock companies are required, after obtaining approval by resolution at the ordinary general meeting of shareholders,

to publicly disclose their balance sheets (for large companies, also their profit and loss statements) promptly and without delay (Company Code, Art. 440).

**[ii] The Method for Preparing Financial Statements and Associated Detailed Accounting Documentation**

**[A] Balance Sheets as Prescribed by the Ministry of Justice.** A balance sheet is a type of consolidated corporate financial document that must be compiled for some specified period of time, by a specified point in time (e.g., at the time of incorporation and every fiscal period thereafter), using an itemized and categorized list of the company's assets, liabilities and capital as the reference source and presenting this information in tabulated form, thereby clearly indicating the composition of the company's asset situation. Balance sheets are comprised of three sections, assets (*shisan*), debts or liabilities (*fusai*), and net assets (*junshisan*), and each section requires the entry and/or recordation of the total monetary amount attributable to each section (Corporate Accounting Regulations, Art. 105).

The assets section, as the debit side of the balance sheet, is recorded on the left side of the table, and indicates the ways in which the company has applied invested capital.

The liabilities section, as the credit side of the balance sheet, is recorded on the right side of the table, and indicates the sources of capital procurement for the company.

**[B] Profit and Loss Statements as Prescribed by the Ministry of Justice.** A profit and loss statement (*soneki keisansho*) is a corporate financial document that compares the revenues and expenditures during the course of a fiscal year, and indicates the company's bottom line in terms of its profit and loss for that period. In contrast to the balance sheet, which shows a stock company's business operations in static terms, the profit and loss statement indicates the movements of the company's business activities.

**[C] Business Reports as Prescribed by the Ministry of Justice.** A stock company's business report is a document detailing the company's operational trends or directions, as well as the company's general condition, for the past fiscal year. The business report is required to contain any specific, important information regarding the company's condition as well as details regarding any decisions or formal resolutions made regarding corporate internal control measures (Regulations Concerning the Application of the Company Code, Art. 118).

**[D] Accounting Statement of Changes in Equity, Etc.** Under the Company Code, the increase in capital surplus resulting from the distribution of profits, diminution of capital stock, etc., the decrease in capital surplus resulting from disposal of the company's own stock, the depletion of corporate capital reserves, etc.--in other words, those transactions that are not profit and loss transactions *per se* for the stock company, but affect the company's calculation of its net assets--are required to be set forth in a separate accounting document and prepared as the statement of changes in equity, etc., (*kabunushi shihon to*), as prescribed by law (Company Code, Art. 435; Corporate Accounting Regulations, Art. 91 Para. 1).

**[E] Explanatory Charts.** Explanatory charts (*chukihyo*) collect and contain information such as notes explaining underlying assumptions relating to ongoing business activities, notes explaining details relating to important accounting policy matters, explanatory notes relating to the profit and loss statement, etc. (Company Code, Art. 435 Para. 2, Corporate Accounting Regulations, Art. 91 Para. 1).

**[F] Associated Detailed Statements Prescribed by the Ministry of Justice.** Associated detailed statements (*fuzoku meisaisho*) are records and documents that contain important details supplementing the information contained in the balance sheet, profit and loss statement, accounting statement of changes in equity as well as the content of the individual explanatory charts (Company Code, Art. 435, Corporate Accounting Regulations, Art. 145).

**[iii] Capital and Reserves**

**[A] Capital.** The amount of a stock company's capital is, generally speaking, the monetary value of its assets

(either in the form of cash payments or provision of in-kind contributions) received by the company in exchange for its initial issuance of stock at the time of its incorporation or the issuance of new stock (Company Code, Art. 445 Para. 1). However, it is permissible for stock companies to capitalize as little as one-half of the amount received in the form of such payments and asset provision (Company Code, Art. 445, Para. 2). The cash and other assets that are not capitalized at the time of incorporation become the company's retained capital earnings (*haraikomi joyokin*) and are set aside as the company's capital reserves (Company Code, Art. 445, Para. 3). The amount of capital becomes public information upon registration (Company Code, Art. 911 Para. 3 Item 5).

**[B] Capital Reserves (*junbikin*).** Capital reserves are calculated based upon a fixed formula that provides for the mandatory retention of a portion of the amount of the company's net assets in excess of the capital according to the balance sheet. Capital reserves fall under the capital category on the balance sheet. There are two general types of capital reserves, the legally mandated capital reserves (*hotei junbikin*) which are reserves set aside in accordance with statutory law, and voluntarily maintained capital reserves (*nin'i junbikin*) which are set aside in accordance with the terms of the corporate articles and bylaws, or pursuant to a resolution passed at the general meeting of shareholders; legally mandated capital reserves also can be further categorized as earned reserves (*rieki junbikin*), which are capital reserves allocated from a portion of the company's earnings from a fiscal year, and capital reserves from paid-in capital (*shihon junbikin*) which are capital reserves sourced from assets that are required to be allocated as capital, such as a portion of the payments made by the initial investors at the time of incorporation.

**[C] The Use of Capital Reserves and the Capitalization of Retained Earnings Into Capital Stock and Capital Reserves.** A Stock Company may reduce the amount of capital reserves. (Company Code, Art. 448, Para. 1). As a general rule, reductions in amount of reserves shall be decided by resolution of a shareholders meeting, however, in certain cases that may be decide by the directors (or, for a company with board of directors, resolution of the board of directors). (Art. 448, Para. 3). Also, company may increase the amount of its stated capital by reducing the amount of its surplus. (Company Code, Arts. 450 and 451, the same applies to the capitalization of legally mandated capital reserves).

**[iv] Distribution of Retained Earnings.** The distribution of a stock company's retained earnings (*joyokin no haito*) as dividends to the shareholders may take place at any time and with any frequency, upon passage of an ordinary resolution of the general meeting of shareholders approving the distribution (Company Code, Arts. 453, 454 Para. 1). Also, it is permissible to make non-monetary distributions (however, midterm dividends are limited to monetary payouts; *see* Company Code, Art. 454 Para. 5); this is referred to as distribution of in-kind dividends, but in order to make distributions that are exclusively in-kind, a special resolution of the general meeting of shareholders is required (Company Code, Art. 309 Para. 2 Item 10).

The maximum amount of retained earnings that may be distributed is referred to as the distributable amount (*bunpai kano gaku*), and the distributable amount is the equal to the sum that subtracted a sum of treasury stock from a sum of money and other asset (Company Code, Art. 446; refer also to Art. 461). Furthermore, even if there are retained earnings, such funds may not be distributed as dividends if (excluding the amount of capital) the corporate net assets are less than three million yen (Company Code, Art. 458).

In order to distribute retained earnings, it is necessary to pass a resolution of the general meeting of shareholders determining: 1) the type of assets being distributed; 2) as to the shareholders, the terms relating to the allocation method for the assets being distributed; and 3) the date upon which the right to receive the distribution becomes enforceable (Company Code, Art. 454).

Where a company makes a distribution even though it has no surplus that may be legally distributed (strictly stated, an illegal dividend), liability regarding such a distribution arises for the persons responsible for receiving the issuance of money payments, as well as Executing Persons, responsible for making the distribution (Company Code, Art. 462). The company may file an unjust enrichment claim against its shareholders and demand them to return the illegal distributions.

Regarding restitution liability concerning distributed amounts, liability for any part of the distribution in excess of the distributable amount cannot be waived at all, and even where liability to repay distributed amounts up to only the maximum distributable amount is made the subject of a release, the approval of the general meeting of shareholders is necessary (Company Code, Para. 3).

Where an illegal dividend has been distributed, the accounting counselor, auditor and accounting auditor are deemed to have negligently breached their duty of care, and are jointly and severally liable for compensatory damages to the company (Company Code, Art. 423). The law also contains provisions regarding third-party liability (Company Code, Art. 429).

Additionally, companies with a board of directors and, as prescribed in their bylaws, operate on one-year fiscal year cycles may, by a resolution of their boards of directors and limited to one time per year, distribute cash dividends to their shareholders on a specified date in the middle of the fiscal year (interim dividends or *chukan haito*, Company Code, Art. 454 Para. 5). Restrictions on the distributable amounts of interim dividends and the duties and liability of officers, etc., thereto are the same as those applicable to the distribution of retained earnings as discussed above.

**[v] Shareholders' Right to an Accounting Inspection.**

**[A] Right to Review the Corporate Accounting Books.** Shareholders holding three percent or more of the total shareholder voting rights, or holding quantitatively three percent or more of the outstanding issued stock, have the right to request to review or copy the company's accounting books at any time during the company's regular hours of business (Company Code, Art. 433 Para. 1). For a shareholder to demand to review the accounting books, etc., it is necessary for the shareholder to submit a written request stating the reason for the request to the company (Company Code, Art. 433 Para. 1); however, the shareholder does not have to prove factually that that the reason given for the request is objectively justifiable (Supreme Court Judgment, 2004.7.1, *Minshu* 58.5.1214). Where certain circumstances exist and cause the company to suspect that the shareholder is abusing his rights to an accounting inspection, the company may, with a showing of adequate grounds, deny the shareholder's request to review the corporate accounting books (Company Code, Para. 2).

**[B] Demand for Appointment of an Inspector.** Where there is suspicion that material facts exist showing that a company's directors or other management executives company have engaged in improper conduct, such as violations of statutory law or the company's bylaws, shareholders holding three percent or more of the total shareholder voting rights, or holding quantitatively three percent or more of the outstanding issued stock, have the right to file a court petition requesting judicial appointment of an inspector (*kensayaku*) to investigate the company's business affairs and circumstances (Company Code, Art. 358, Para. 1).

Improper conduct in this context refers to acts by directors that are to the detriment of the company and intended to benefit the directors or third parties. A violation of statutory law is not restricted to violations of the provisions of the Company Code; any violation of statutory law may give rise to the demand. However, where there is a suspicion that statutory law has been violated, the existence of particularly material facts must be alleged, and the materiality of the facts at issue will be the court's primary criteria for making a decision regarding the propriety of appointing an inspector to investigate corporate affairs (Osaka High Court Judgment, 1980.6.9, *Hanrei Times* 427,178).

The inspector who is judicially appointed may also investigate the business affairs and asset situation of the company's subsidiaries, if it is necessary for the performance of his job duties (Company Code, Art. 358 Para. 4). The investigative results of the inspector are reported to the court, with copies of the report also being provided to the company and the petitioning shareholder (Company Code, Art. 358, Para. 5 Item 7).

**[C] Right to Demand Delivery and Review of the Financial Statement (Company Code, Art. 442 Para. 3).** The original copies of the balance sheet and other parts of the corporate financial statement, as well as the associated

detailed statements and the auditor's (or accounting auditor's) audit report must be kept at the stock company's principal office for a period of five years, starting two weeks prior to the applicable general meeting of shareholders, and copies of these documents must be maintained for three years at the stock company's branch offices (Company Code, Art. 442 Para. 1 Item 2). Shareholders and obligees of the company may demand to review these documents, or production of a photocopy or abstract thereof, at any time during regular business hours (Company Code, Art. 442, Para. 3).

**[k] Fundamental Alterations to the Stock Company**

**[i] Amendment of the Articles and Bylaws**

**[A] Procedure for Amendment of the Articles and Bylaws.** Amendment of the articles and bylaws occurs pursuant to special resolution by the general meeting of shareholders (Company Code, Art. 309 Para. 2 Item 11, Art. 466).

Where the company has issued different classes of shares and the proposed amendment of the bylaws would inure to the detriment of a class of shares, in addition to the required shareholders' resolution, a resolution of approval from a meeting of the shareholders of the potentially impacted class is necessary (Company Code, Art. 322). The amendment of the bylaws takes effect upon shareholder ratification. Memorialization in writing or electromagnetic recording is not a requirement.

**[B] Amendment of the Quantity of Total Issuable Stock by the Company.** Stock companies may, as required, amend their bylaws to increase their quantity of issuable stock (Company Code, Arts. 113), but public companies must issue the quantity to an extent greater than four times the quantity of stock issued at the time of incorporation (Company Code, Art. 373 Para. 3). Therefore, where a public company seeks to increase its quantity of total issuable stock after incorporation by amending its bylaws, the increased quantity may not exceed four times the outstanding issued stock at the time of such an amendment (Company Code, Art. 113 Para. 3).

**[C] Restrictions on the Transfer of Stock.** As to restrictions placed on the transfer of company stock, other than prescribing such restrictions in the initial articles and bylaws at the time of incorporation, it is also possible to create such restrictions by amending the bylaws. However, the procedure prescribed is more onerous than those applicable to ordinary amendments of the bylaws (Company Code, Art. 309 Para. 3), and additionally the right of stockholders who oppose such an amendment to exercise their rights of appraisal and demand a buy-back of their stock holdings by the company is recognized by law (Company Code, Art. 116).

**[ii] Diminution of Capital Stock and Capital Reserves.** The diminution of a stock company's amount of capital come in two types: 1) in conjunction with a diminution of company assets (actual capital diminution); and 2) not in conjunction (nominal capital stock diminution). While the Company Code prohibits the total depletion of corporate capital, there are no provisions specifically restricting the extent to which corporate capital may be diminished.

Under the new Company Code, the diminution of the capital stock amount is achieved independently of the reduction of the quantity of corporate stock (Company Code, Art. 447). Although a stock company can diminish its amount of stock capital along with reducing the quantity of stock, and/or pay back something to its shareholders, it should be noted that carrying out the diminution of the quantity of stock capital under Article 447 of the new Company Code is only a change of the figures as to the company's amount of capital stock. This is different from the method for diminution of the amount of capital stock under former Commercial Code Art. 375.

A company can pay back money or other in-kind counter-value to its shareholders along with diminution of amount of capital stock (without reacquiring its own shares), if the total amount being distributed does not exceed the permissible amount of distribution (Company Code Art. 461 Para. 1). If a company wants to do this, it must follow the procedures for the distribution of earned surplus (for details, *see supra* § 2.10.4).

The company can reduce the quantity of outstanding stock and diminish the amount of capital stock by acquiring its own shares. This can be achieved under the various procedures available for the reacquisition of corporate shares (*see supra* [3]). Alternatively, this can be achieved through exercising the option on stock with a reacquisition option owned by the issuing company (*shutoku jokotsuki kabushiki*) or on stock with an option for reacquisition of all stocks by the issuing company (*zenbu shurui kabushiki*, Company Code, Art. 108 Para. 1 Item 7). To reacquire the stock, a special resolution at a general meeting of shareholders is required (Company Code, Art. 171 Para. 1, Art. 309 Para. 2 Item 3). In these cases, the issuing company (i.e., the reacquiring company) can pay money or other in-kind counter-value to the shareholders if the total amount does not exceed the permissible amount of distribution (Company Code, Art. 461 Para. 1, Item 4).

Another method in which the quantity of outstanding shares may be reduced is by the consolidation of shares (*kabushiki heigo*, Company Code, Art. 180), where the company takes multiple shares of stocks and consolidates them into a smaller quantity of shares.

The quantity of stock owned by the issuing company (i.e., the quantity of treasury stock), separately from the quantity of its outstanding shares, may be reduced by redeeming specific shares of stock (*kabushiki no shokyaku*, Company Code, Art. 178).

The diminution of capital is generally a matter to be decided by a special resolution of the general meeting of shareholders (Company Code, Art. 309 Para. 2 Item 9; refer also to Art. 447 Para. 1).

Additionally, it is possible to reduce the legal capital reserves upon passage of an ordinary resolution to that effect by the shareholders at their general meeting (Company Code, Art. 448).

In the event that a stock company engages in the diminution of its capital or capital reserves, excluding instances where the amount taken from the capital reserves is injected entirely into the capital, the company's obligees are permitted to raise objections regarding the action (Company Code, Art. 449 Item 1 text). Provided, however, that where only the capital reserves are drawn against the claim that obligee protection is required is not considered strong (Company Code, Art. 449 Item 1 text, *see* proviso thereto). A failure by the obligees to object to the debtor company's diminution of capital constitutes implied consent of the action and waives their right to object to the diminution (Company Code, Art. 449 Item 4).

The process for carrying out the diminution of capital differs depending on the method of capital reduction: 1) where the diminution does not correspond to a diminution of stock share quantity, as a general rule there is no special procedure that is required, but whether the procedure for the intended reduction involves reimbursing shareholders, actual payment of the reimbursement is required; 2) acquisition of stock for voluntary retirement is executed according to the terms of the contract between the company and the shareholder, but where the contract calls for compensated retirement, the compensatory payment must be made prior to retirement (Company Code, Arts. 160, 161 and 178); and 3) where a company seeks to reduce its capital by stock consolidation, it is necessary for the company to publicize or otherwise notify its shareholders, etc., of the details pertaining to the stock consolidation at least two weeks prior to the consolidation date (Company Code, Arts. 180 and 181).

The capital diminution becomes successful only after the company has obtained the consent of the shareholders by special resolution and completed the processes for both obligee protection and the actual carrying out of the reduction (Company Code, Art. 449, Para. 6).

Where there is a procedural or material defect in executing the capital diminution by the stock company, the law recognizes actions seeking to invalidate the company's capital diminution based on the defect in execution (Company Code, Art. 828 Para. 1 Item 5, Para. 2, Item 5).

**[iii] Change of Business Organization Type**

**[A] Procedure for Change.** Changing the type of business organization refers to conversion of the legal characterization of a company, from a stock company into an *mochibun* company (non-stock company types recognized under the Company Code) or vice versa (Company Code, Art. 2 Item 26). Where a stock company is changed into an *mochibun* company, first it is necessary to prepare a change of organization type plan (*soshiki henkou keikaku*), containing information such as the type of non-stock company (e.g., *gomei gaisha*, *goshi gaisha*, etc.) into which the stock company will be changed, the business purpose of the company after the change, the company name, the terms for the distribution of cash and other dividends to shareholders prior to the change, including allocation and date of distribution, etc. (Company Code, Art. 744 Para. 1).

A stock company undergoing a change in organization type must, prior to the date upon which the change becomes legally effective, obtain shareholder approval of the plan for the change of organization type by a resolution of the general meeting of shareholders (Company Code, Art. 776 Para. 1), and in addition, procedures on dealing with known persons of interest in the change, such as providing notification, etc., are required (Company Code, Art. 776 Para. 2, Art. 775, Art. 777, Para. 2).

**[B] Invalidity of Change in Organizational Type.** Where there is a procedural or substantive defect in changing a company's organizational type, the attempted change is void. Specific grounds for invalidating an attempted change of organizational type include failure to redeem all of the company's outstanding debt instruments, without the consent of all shareholders (Company Code, Arts. 830 and 831). A claim asserting the invalidity of a company's change of organizational type is brought as an action to invalidate executive conduct relating to company organization (Company Code, Art. 828).

**[iv] Mergers and Consolidations**

**[A] Overview.** Mergers and consolidation (collectively *gappei*) refers to the amalgamation of multiple business organizations, each with its own juridical person status, into a single corporate juridical person. Merger, or merger by absorption (*kyushu gappei*), occurs where one existing company is chosen as the single successor company, with the other constituent companies dissolved as independent legal entities and absorbed into the successor company (Company Code, Art. 2 Item 27); consolidation, or consolidation into a new company (*shinsetsu gappei*), occurs where all of the constituent companies being consolidated are dissolved and incorporated into one new company that is established by the dissolution and consolidation (Company Code, Art. 2 at Item 28).

Each of the four types of *kaisha* recognized under the current Company Code may freely merge or consolidate with any of the other types of companies (Company Code, Art. 748). However, a stock company may not attempt to continue its corporate existence through a merger if it was dissolved prior to the attempted merger (Company Code, Art. 474 Item 1). Also, certain mergers or consolidations may be restricted or prohibited under the Antimonopoly Act (Law No. 154, 1947, Art. 15 Para. 1)

Traditionally, in a merger the shareholders of the company being absorbed were given shares of stock in the acquiring company itself, but the Company Code allows other types of compensation to be provided, such as stock in the parent company or a buyout of shareholders by payment of cash or other assets of value. The issuance of parent company stock to shareholders of the company being absorbed is referred to a triangular merger (*sankaku gappei*), and where shareholders of the company being absorbed are paid cash or other consideration, this is referred to as a "cash out merger," with those person ceasing to be shareholders for the purposes of the merger. This is referred to as the trend toward flexible counter-payment in *gappei* (*gappei taika no junanka*), although it is worth noting that other forms of corporate reorganization also receive the same treatment under the Company Code.

**[B] Procedure for Mergers and Consolidations.** The Company Code, as set forth above, considers merger by absorption and consolidation into a new company separate and distinct forms of *gappei*, and establishes separate

procedures for each; however, the explanation of *gappei* provided in this section focuses on the type of *gappei* in which two stock companies are merged by absorption.

In order for a company to merge with another, a contract agreeing to the merger must be prepared by the constituent companies (Company Code, Art. 748). The merger agreement must contain certain terms, including the names of the constituent companies, addresses, merger ratio (*gappeihiritsu*), the effective date of the merger, etc. (Company Code, Art. 749).

In entering into a contract for the merger by absorption of stock companies, the constituent stock companies are required to keep and maintain a copy of the merger agreement, as well as documents and records containing such information as required by the Ministry of Justice and prescribed by ordinance, at the merged company's principal office, from the date upon which the merger agreement is executed (where the agreement is approved by shareholder resolution, two weeks prior to that date) until six months after the merger has taken effect (Company Code, Art. 782, 794). The company must make these documents available to shareholders and company obligees to review or to photocopy (Company Code, Art. 782 Para. 3, Art. 794 Para. 3).

As a general rule, the stock companies involved in the merger are required to obtain their shareholders' approval of the merger agreement at least one day prior to the date upon which the merger takes effect (Company Code, Arts. 783 and 795). Such approval ordinarily must be by the passage of a special resolution (Company Code, Art. 309 Para. 2 Item 12), and the notice convening the general meeting of shareholders for the approval is required to explain the special way in which the agenda item must be decided (Company Code, Art. 299 Para. 4, Art. 298, Para. 1, Item 2).

Shareholders who oppose the merger can exercise their rights of appraisal and demand buy-back of their stock by the company (Company Code, Arts. 785 and 797). Also, the constituent companies must implement security procedures for the protection of their obligees (Company Code, Arts. 789 and 799).

Regarding the merger ratio, in order to make the allocation of new stock in the merged company to stockholders of the dissolved company a smooth process (issue at a 1:1 ratio), the company being dissolved may choose to implement proceedings to consolidate or split stock prior to effectuation of the merger.

**[C] Result of *Gappei*.** Once the *gappei* takes effect, in the case of merger by acquisition, excluding the successor company, all of the constituent companies participating in the merger are dissolved (Company Code, Art. 471 Item 4), and cease to exist without undergoing liquidation proceedings (Company Code, Art. 475 Item 1). In the case of consolidation into a new company, the consolidation results in the creation of a new company that incorporates as its shareholders all of the shareholders of its constituent companies.

Upon merger or consolidation, all of the rights and duties associated with the dissolved companies are transferred in their entirety to the successor company or newly created company; no particular acts are required to effectuate this transfer (Company Code, Arts. 750, Para. 1 and Art. 754, Para. 1).

**[D] Invalidation of Merger or Consolidation.** Where there is a procedural or substantive defect in an attempted merger or consolidation it is void. Specific grounds for invalidation of a merger or consolidation include the successor company or new company's inadequacy, the failure to execute a merger agreement contract, and the cancellation, invalidation, or non-existence of the shareholder resolution purporting to approve the merger or consolidation (Company Code, Arts. 830 and 831).

As to whether an unfair or unreasonable stock allocation ratio is grounds for invalidation of a merger or consolidation, there is at least one lower court that has held that in light of the fact that shareholders rejecting the merger or consolidation agreement can exercise their rights of appraisal to have the company buy back their stocks, the fact that the merger or consolidation ratio is unfair or unreasonable is not in itself grounds for invalidating the merger or

consolidation (Tokyo District Court Judgment, 1989.8.24, *Hanreijiho* 1331.136).

An action to invalidate a merger or consolidation, like other actions seeking to invalidate executive actions relating to the corporate structure, are subject to restrictions regarding standing to sue, applicable statutes of limitations, etc. (Company Code, Arts. 828, Para. 1, Item 7, Para. 2 Item 7, and 8). Where the merger or consolidation violates Article 15 Paragraph 2, 4, 5 of the Antimonopoly Act, the Fair Trade Commission also has standing to sue for invalidation (Antimonopoly Act, Art. 18).

A judgment invalidating a merger or consolidation is valid and enforceable as against the world; however, it has no retroactive effect (Company Code, Arts. 838, 839).

**[v] Company Division**

**[A] Company Division--Significance and Form.** Company division (*kaisha bunkatsu*) takes one of two forms. One is where the division is limited to the transfer of business operations from Company A to newly established Company B, with Company B issuing its initial stock issuance to Company A in exchange (organizational spin-off or *bunshagata bunkatsu*); the other is where Company A transfers business operations to newly established Company B, with Company B distributing its initial stock issuance to Company A's stockholders (complete spin-off or *bunrigata bunkatsu*).

Company B, which succeeds Company A as to its business operations, does not necessarily have to be a newly established company. Where Company B is a previously existing company this is referred to as division by absorption (*kyushu bunkatsu*, Company Code, Art. 2 Item 29); where Company B is a new company it is called division by establishment of a new company (*setsuritsu bunkatsu*, Company Code, Art. 2 Item 30).

The rules for division by absorption are essentially the same as those for division by establishment of a new company; therefore this section explains the rules that apply under the Company Code where a stock company is newly established for the purpose of business division. Additionally, the Company Code prescribes that only stock companies and limited liability companies may carry out a division of their business (Company Code, Arts. 757 and 762). However, there are no statutory restrictions upon the type of company that may be the successor to the divested business, whether in the case of division by absorption or division by establishment of a new company (Company Code, Arts. 760 and 765).

**[B] Procedure for Company Division.** To carry out a corporate division, it is necessary to prepare a written plan for company division (*bunkatsu-keikakusho*) (Company Code, Art. 757). The division plan should contain information regarding details such as the terms of the new company's articles and bylaws, the names of the initial directors and officers, etc., the assets, liabilities, employment contracts, and other rights and obligations that are to be assumed by the successor company, etc. (Company Code, Arts. 762 and 763 Item 1).

As a general rule, a division plan must be approved by special resolution at the general meeting of shareholders in order to be implemented (Company Code, Art. 309 Para. 2, Art. 804), and shareholders in opposition to the division can exercise their rights of appraisal and demand a buy-back of their stock by the company (Company Code, Art. 806). Also, there are procedures in place for the protection of company obligees (Company Code, Art. 810).

**[C] Company Division--Result and Invalidation.** A division by establishment of a new company becomes effective upon the registration of the new company's incorporation (Company Code, Art. 764; for division by absorption, *see* Art. 758 Item 7, Art. 759).

In a division by establishment of a new company, the legal rights and obligations relating to the business being divested are naturally transferred to the new successor company upon the completion of the division in accordance with the division plan (total succession).

As to what results from carrying out company divisions, in the case of an organizational spin-off, the company that has executed the division by establishment of a new company becomes the sole parent company of the new company, and in the case of a complete spin-off, the new company's stock is distributed to the shareholders of the divesting company, who become the shareholders of the new company.

Where there is a procedural defect in carrying out a company division, the law contains provisions permitting actions to invalidate the company division that are the same as actions to invalidate other types of actions relating to the corporate organization, and as with the other invalidation actions there are certain restrictions regarding standing to sue, statutes of limitations, scope of enforceability, retroactivity, etc. (Company Code, Art. 828).

**[vi] Stock Swap and Stock Transfer**

**[A] Stock Swap.** A stock swap refers to the situation in which a stock company has all of its outstanding issued stock acquired by another stock company or limited liability company (Company Code, Art. 2 Item 31).

Stock companies may conduct stock swaps for the purpose of acquiring all of the outstanding issued stock in another company, with the result that a complete parent-subsidiary company relationship is created (Company Code, Art. 767). Limited liability companies are also capable of becoming parent companies with total ownership, but limited partnership companies and partnership companies are not (Company Code, Art. 770).

Carrying out a stock swap requires the execution of a written stock swap agreement (Company Code, Art. 767, 768), and it is necessary to obtain shareholder approval of the agreement by passage of a special resolution (Company Code, Art. 795, Art. 309, Para. 2, Item 12). Shareholders who oppose the stock swap have the right exercise their appraisal rights and demand a buy-back of their stock by the company (Company Code, Art. 797).

Where there is a procedural defect in carrying out a stock swap, the law contains provisions permitting actions to invalidate the stock swap, as it is recognized as a type of act relating to the corporate organization subject to invalidation (Company Code, Art. 828 Para. 1 Item 11).

**[B] Stock Transfer.** A stock transfer refers to the situation in which one or more stock companies transfer all of their outstanding issued stock to a newly established company which becomes the sole shareholder of that stock (Company Code, Art. 2 Item 32).

Companies are permitted to carry out stock transfers for the purpose of creating wholly-owned subsidiaries (Company Code, Art. 772). In a stock transfer, the stock of the company that is to become the wholly owned subsidiary is transferred to the company that is established in order to become the sole parent company, and upon completion of the stock transfer, the shareholders of the company becoming the wholly owned subsidiary are issued stock in the parent company at the proper allocation ratio, and become shareholders of the parent company (Company Code, Art. 774, Para. 1-3).

In order to carry out a stock transfer, the company must obtain the approval of stock transfer plan, by passage of a special resolution of the general meeting of shareholders (Company Code, Art. 804). Also, shareholders' rights, actions for invalidation, etc., relating to a stock transfer are treated by the Company Code essentially in the same way as stock swaps; for example, shareholders who oppose the stock transfer can exercise their appraisal rights to demand a buy-back of their stock by the company (Company Code, Art. 806).

**[l] Dissolution and Liquidation**

**[i] Overview.** The dissolution of a company (*kaisha no kaisan*) refers to the legal and factual conditions that constitute the termination of the company as a legally recognized entity. Excluding merger and consolidation, a

company's juridical person status (*hojinkaku*), is not immediately extinguished by dissolution; instead, the company enters into liquidation (*seisan*) proceedings, and the company continues to exist until it satisfies or otherwise winds up its existing legal relationships, and ceases to exist only upon completion of the liquidation process. While in liquidation proceedings, the company can be thought of as still in existence, but within the context of its status as a subject of liquidation (Company Code, Art. 476).

Liquidation is the procedural system that aims to wind up the existing legal relationships of a company in dissolution in a smooth and orderly manner. The grounds for dissolution are prescribed by statute as follows: 1) the completion of the prescribed term of corporate existence or the vesting of other grounds for dissolution, as prescribed in the articles and bylaws; 2) the passage of a resolution to dissolve the company at the general meeting of shareholders; 3) merger or consolidation; 4) the decision to file for bankruptcy proceedings; and 5) a judicial order of dissolution (Company Code, Arts. 471, 824, and 833).

Where continuing with the business operations of the company has become considerably onerous and the damage to the company is beyond recovery, or where the corporate asset management and/or disposal has been so poorly performed that the company's continued existence is at imminent risk, if there are any unavoidable grounds, a shareholder of the company with one-tenth or more of the voting rights (or one-tenth of the outstanding issued stock) may petition a court to judicially order the company's dissolution (Company Code, Art. 833). Compelling grounds for the dissolution of the company are understood to exist when there is no other way to reasonably protect the interests of the company or its shareholders other than to dissolve the company.

Upon corporate dissolution, excluding instances of merger, consolidation or bankruptcy, the company enters into liquidation proceedings (Company Code, Art. 475 Item 1). Stock company liquidation is distinguished by the fact that voluntary liquidation is not permitted; the company must conduct liquidation proceedings strictly as prescribed by the law.

The identity of the company does not change after deciding upon dissolution once it enters into liquidation proceedings, with the only change being that once it becomes a subject of liquidation, the company's rights capacity is limited to those defined by law to be permissible within the scope of liquidation proceedings.

The board of directors of a company in liquidation proceedings ceases to exist, and executive authority during liquidation proceedings is conferred upon the liquidator (*seisan nin*), but the company maintains its character as a commercial entity, and the company name remains the same. However, as a general rule the company may not continue to pursue its traditional business operations while in liquidation proceedings (Supreme Court Judgment, 1967.12.15, *Minshu* 25.7.962). The rules and regulations applicable to the company prior to liquidation continue to apply to the company even after entering liquidation proceedings, to the extent their application does not conflict with the primary objective of corporate liquidation (Company Code, Arts. 476-478).

There are two types of legal liquidation, ordinary liquidation (*tsujo-seisan*) and special liquidation (*tokubetsu seisan*), the latter being where there is interference with the execution of the liquidation, or the likelihood of excessive company debts makes close judicial supervision necessary. Only stock companies are subject to special liquidation (Company Code, Arts. 510-574).

**[3] Non-Stock Companies**

**[a] Partnership Company (*gomei gaisha*)**

**[i] Formation.** The Company Code categorizes all companies other than stock companies (*gomei gaisha, goshi gaisha and godo gaisha*) as non-stock companies (*mochibun gaisha*) and prescribes uniform laws for them.

A partnership company (*gomei gaisha*) is a type of company made up entirely of general partners, or *mugensekinin shain* (Company Code, Art. 576 Para. 2). General partners are company equity members who, as against the company's obligees, jointly and severally bear direct, personal liability for the company's obligations (Company Code, Art. 580 Para. 1). Unless otherwise specifically prescribed in the company's articles and bylaws, each and every one of the general partners has the authority to manage the company's business and to officially represent the company (Company Code, Arts. 590 and 599). Even in internal matters the individuality of the partners is stressed, and thus it is difficult to transfer partnership status to a third party (Company Code, Art. 585), and amendment of the articles and bylaws requires the unanimous consent of the general partners.

In order to establish a partnership company, all that is necessary is for the persons seeking to become general partners to prepare articles and bylaws (Company Code, Art. 575) and register the company (Company Code, Art. 579). What is more, generally speaking there is no need to elect general partners of a partnership company because they are the ones preparing the company's articles and bylaws; also, those general partners also automatically become the company's decision-making body, and thus no special procedures are required to organize these aspects of a partnership company.

Also, under the Company Code, even juridical persons may become members of a partnership company. In the event that a juridical person becomes a member with executive decision-making authority, it must select and appoint an individual to actually take on those duties, and the name and address of this individual must be provided to the other general partners (Company Code, Art. 598, Para. 1).

Investments in partnership companies may be made in the form of credit investments (*shinyo shusshi*) or labor investments (*romu shusshi*) and not just asset investments (Company Code, Art. 576 Para. 1, Art. 582, Art. 611 Item 3).

If there is an illegality in the formative process, the establishment of the company is invalid. However, because with partnership companies the individual interests of the members are stressed, the subjective objections of a member, such as his belief that the intentions of one or more of the members was defectively expressed regarding some act of establishment, is sufficient to not only excuse that member from participation, but may be grounds for the invalidation or cancellation of the establishment of the company itself.

The Company Code's provisions regarding bringing actions in law to invalidate or cancel the establishment of a partnership company, and the methods of assertion, statute of limitations, legal effect, etc., are in large part the same as those applicable to the provisions for seeking invalidation of incorporations (Company Code, Arts. 644, 828, 832, and 835, 838, 839).

**[ii] General Partners.** Identification of the general partners of a partnership company is a mandatory term for the company's articles and bylaws, and changes regarding the members of the partnership require amendment of the articles and bylaws. In order to allow a new member to join the partnership, unanimous approval from the existing partners is required (Company Code, Arts. 637 and 604), and the new partner becomes liable jointly and severally for all of the company's financial obligations, including those that existed before he joined the company (Company Code, Art. 605).

General partners must announce their intention to withdraw from the partnership at least six months in advance; if this condition is satisfied they may withdraw at the end of the fiscal year (Company Code, Art. 606, Para. 1). However, under truly unavoidable circumstances a partner may withdraw from the partnership at any time (Company Code, Para. 3). Upon withdrawal, the former partner's equity share reverts to the partnership company (Company Code, Art. 611); however, the former partner continues to be liable for the company's financial obligations incurred prior to registration of his withdrawal (Company Code, Art. 612).

General partners of a partnership company have investment duties to the company on one hand; on the other hand, they also possess both rights relating to their own self-interest (such as the right to demand the distribution of dividends) as well as common rights (the right to make executive decisions, the right to officially represent the company, etc.)

A partnership company's executive decision-making process is conducted by a vote of the executive managing partners, with a simple majority (unless otherwise prescribed by the company, this includes all of the general shareholders) of votes required to approve a decision (Company Code, Art. 590, Para. 1 and 2).

**[iii] General Partnerships: Assignment and Reversion.** The partners of a partnership company only possess their individual interest of the partnership, but depending on the investment contributions made the size of the interest possessed by each of the partners will differ. Upon the consent of all of the other partners, a partner may assign all or part of his partnership interest to another person (Company Code, Art. 585).

**[iv] Dissolution.** A partnership company shall dissolve on the grounds listed below: the expiration of the duration provided for in the articles of incorporation, the grounds for dissolution provided for in the articles of incorporation having arisen, the consent of all partners and the absence of all partners, etc. (Company Code, Art. 668).

Where circumstances make it unavoidable, a partner may petition the courts for a judicial order of dissolution against the partnership company (refer to Company Code, Art. 833, Para. 2).

**[b] Limited Liability Partnership Companies.** The limited liability partnership companies (*goshi gaisha*) is a type of company in which the ownership is comprised of general partners (*mugensekinin shain*) and limited liability partners (*yugensekinin shain*). The same rules that apply to the general partners of partnership companies also apply to the general partners of limited liability partnership companies; however, limited liability partners are not jointly and severally liable to obligees for all of the company's financial obligations, their financial exposure being limited to their investment stakes in the partnership (Company Code, Art. 580 Para. 2). However, because the liability of limited liability partners to company obligees is considered to be personally and directly owed, their liabilities are of a different legal nature than the derivative limited liability of stockholders.

As a general rule, all of the partners of the company possess management decision-making authority (Company Code, Art. 590), although it is possible to delegate this authority to certain partners by prescribing it in the articles and bylaws (Company Code, Art. 591). However, where the management decisions of the partnership injures a third party entitling that party to demand compensation from the company, liability to provide compensation is imposed on not only the general partners, but also on limited liability partners who have management decision-making authority (Company Code, Art. 597). As for partners who are not involved in management decisions, their responsibilities are limited to monitoring the company's business activities and asset situation (monitoring right, Company Code, Art. 592).

Unless an official representative of the company is designated in the articles and bylaws, each and every one of the executive managing partners has the authority to act in a representative capacity (Company Code, Art. 599).

The investments of limited liability partners are limited to asset contributions, and they are not allowed to make contributions of labor or credit (Company Code, Art. 576 Para. 1 Item 6). In order for a general partner to assign his partnership interest to another person, it is necessary for him to obtain the consent of all other partners to the assignment, including all of the limited liability partners (Company Code, Art. 585 Para. 1).

In contrast, in order for a limited liability partner without management duties to assign his partnership interest, it is only necessary that he receive the consent of all of the executive managing partners, not the entire partnership (Company Code, Art. 585, Para. 2).

**[c] Limited Liability Companies.** Limited liability companies (*godo gaisha*) are noteworthy in that while the limited liability of company equity members is legally recognized, the internal relationships within the company involve a very high degree of personal association, much like limited partnerships, and the company rules are indicative of this. Even though the members are all limited liability members, it is nevertheless necessary to obtain the unanimous consent of the members in order to amend the articles and bylaws after establishment of the company (Company Code, Art.

637). Additionally, the rules regarding the withdrawal of members, as well as the dissolution and liquidation of the company, are the same as other ownership-based company types.

A limited liability company may be established and operated by only one member (*See* Company Code, Art. 641 Item 4). It is not necessary to register the names, appellations or addresses of equity members of the company who are not involved in the management of the company (Company Code, Art. 914, Para. 6-8). However, the withdrawal of a company member or an assignment of a member's equity interest is subject to unanimous consent of the other members in order to be valid (Company Code, Arts. 585, 604).

In comparison, regarding investments by company members, a paid-up capital system is the method used, and each of the members bears liability subject to that system (Company Code, Art. 578, Art. 580, Para. 2). Also, members of a limited liability company may only make asset investments in the company, and the asset contributed must be monetary; members cannot offer to invest their credit or labor in exchange for membership, as is the case in partnership companies (Company Code, Art. 578).

Additionally, while the authority, duties and responsibilities, etc., of executive managing members of a limited liability company are in large part the same as those of executive managers of other types of non-stock companies, the rules regarding company accounting, etc., are different from those of other non-stock companies. First, the amount of capital of a limited liability company is required to be disclosed in the registration information (Company Code, Art. 914 Item 5). It is possible for the company to reduce the capital amount or honor demands from members regarding reimbursement of their investments (Company Code, Arts. 620 and 624); however, in either case (because returning member investments diminishes capital) it is necessary to amend the articles and bylaws in order to perform these acts (Company Code, Arts. 620, 624 and 626). Also, the amount by which the capital is reduced in order to reimburse member investments may not exceed a certain amount, which is calculated by deducting the distributions of retained earnings from the investment amount on the date that the investment is refunded to the member (Company Code, Arts. 626, Para. 2-3). Finally, the company must implement procedures to protect company obligees in carrying out its diminution of capital and contribution refunds (Company Code, Arts. 627 and 635).

**[4] Penal Sanctions**

The Company Code contains various provisions prescribing criminal penalties for corporate actors, including for aggravated breach of trust (Company Code, Arts. 960-962), endangering company assets (Company Code, Art. 963), use of false documents (Company Code, Art. 964), criminal borrowing-and-depositing (Company Code, Art. 965), excessive issuance of stock (Company Code, Art. 966), bribery (Company Code, Arts. 967-969), illegal payoffs relating to shareholders' exercise of voting rights (Company Code, Art. 970), etc.

Additionally, a new provision for overseas crimes has been newly implemented (Company Code, Art. 971).

Also, the Supreme Court has held that the so-called "fronting money" (*misegane*) act (displaying cash to show one has the necessary funds) constitutes the crime of falsifying entries in authentic notarized documents (*koseishosho genbon fujitsu kisaizai*) under the penal code (Supreme Court Judgment, 1991.2.28, *Keishu* 45.2.77).

As an administrative sanction, fines are imposed where promoters, directors, auditors, etc., have engaged in prohibited conduct as set forth in Article 976 of the Company Code.

**FOOTNOTES:**

(n1)Footnote 1. For additional analysis and summary of the Company Code and related statutes and standards, *see* Chap.1 § 3 (2.07) *supra*.

(n2)Footnote 2. For summaries and analysis of recent statutory enactments and summaries of relevant case law,

etc., relating to company law, *see* Chap.1 § 3 (2.07) *supra*.

(n3)Footnote 3. A type of company created by the former law, the *yugen gaisha* (commonly translated as "limited liability company" in English, but not the same as the new *godo gaisha*) may no longer be organized under the new Act.

(n4)Footnote 4. *Kabushiki gaisha* (also *kabushiki kaisha* or "K.K.") is also commonly translated as "corporation" due to its similarity to that form of business organization under Anglo-American law.

(n5)Footnote 5. Here and hereinafter in this chapter, the terms "companies with a board of directors," "companies with accounting counselors," "companies with auditors," and "companies with board committees" are used as legal terms, to identify these systems of corporate governance under Japanese law.

(n6)Footnote 6. While *hokki nin* has traditionally been translated as "promoter," the role of a *hokki nin* under Japanese law is not necessarily the same as that of promoters under Anglo-American law, and some scholars have argued that the term "incorporator" should be adopted instead, to avoid confusion.

(n7)Footnote 7. A special type of executive officer required by law for companies with board committees, because of the unique, statutory nature of the position the Japanese term *shikkoyaku* has been retained to avoid ambiguity; *see* [7 *infra*.

(n8)Footnote 8. While *torishimariyaku* is generally translated as "director," it is important for the non-Japanese legal practitioner to keep in mind these are comparative terms, and it should not be assumed that a "director" under Japanese law is an exact equivalent of a "director" under Anglo-American corporation law, etc.

(n9)Footnote 9. This title is generally translated as "president" in English, but is not necessarily precisely analogous to the Anglo-American corporate title of president.

(n10)Footnote 10. This title is generally translated as "vice-president" in English, but is not necessarily precisely analogous to the Anglo-American corporate title of vice-president.

(n11)Footnote 11. The term *rieki kyoyo* is neutral (it simply means "giving of benefits"), however it carries a negative connotation in the company law context, as it is understood to refer to the improper giving of benefits discussed herein.