



## **Situations in Japan**

**Submitted by**

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**Company Law Reform in OECD Countries  
A Comparative Outlook of Current Trends**

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## **I. Introduction**

This is a memorandum about the situations in Japan. In Section II, I describe recent trends in Japanese corporate law. In Section III, I briefly respond to the "Issues Note" prepared for the conference.

## **II. Corporate Law Reforms in Japan**

### **1. Reforms in Recent Years**

Corporate law in Japan (mainly codified in the Commercial Code) has been changed more often than other areas of private law in the past fifty years, and the frequency of amendments is even increasing today. In fact, it was amended three times in 1997, and experienced drastic amendments in 1999 and 2000. In addition, important special statutes were introduced so as to provide special rules to supplement general corporate law both in 1997 and 1998 (with amendments in 2000).

The reforms in Japanese corporate law produced by statutory amendments in the past fifty years can be characterized into three distinctive groups. First, rules on corporate finance have been deregulated. For instance, amendments in 1974 permitted the issuance of convertible bonds by a resolution of the board of directors, rather than a resolution of the shareholders meeting. Amendments in 1981 introduced a new means of finance: bonds with stock purchase warrants. Amendments in 1990 liberalized the procedure for issuing preferred stock. Amendments in 1993 liberalized the regulation of debentures and bonds in many respects. These deregulation measures were in most cases undertaken in response to requests made by the business sector looking for new or improved avenues of finance in the capital market. Second, rules regarding corporate governance have been strengthened and the level of regulation has been increased. Amendments in 1974 introduced the requirement of external auditing by CPAs for "large companies" (namely, companies having legal capital of 500 million yen or more, or having debts of 20 billion yen or more). The system of statutory auditors was also strengthened in 1974, when the law was amended to require them to check whether a manager's activities comply with the law, applicable regulations and charter provisions. Amendments in 1993 further strengthened this statutory auditor system. Large companies are required to have at least three auditors, forming the board of auditors, and one of them must be a person who has not been a director or employee for the previous five years (a so-called "outside" auditor). These amendments were in most cases undertaken in response to scandals in certain large companies. These scandals occurred in a variety of forms at different times, including bankruptcy and illegal payments to *sokaiya* (disrupting shareholders at shareholders meetings). Third, the legal infrastructure for permitting and facilitating an organic change of a company has been improved. Amendments (especially in 1997, 1999 and 2000) were aimed at improving the then underdeveloped rules, which established such legal infrastructure. The delay in providing rules in this area can be attributed to the fact that there has not been much demand for organic changes in the market place until

recently. However, the downturn in the economy and increased competition in global markets in recent years have created a huge demand for organic restructuring in Japan.

In 1997, three important amendments were made to the Japanese corporate law. First, a stock option system was introduced. As a result of the amendments, stock options (namely, the right to buy stock at a predetermined price) can now be given to directors and employees of a company under certain conditions. Compared to the U.S, the conditions are restrictive, but many companies have issued stock options to their directors and employees under this new scheme. Second, regulations regarding mergers and consolidations were liberalized. In particular, regulations for creditor protections were liberalized, and individual notices to creditors are now not required in mergers or consolidations. Also, short-form mergers were recognized: a small-scale merger no longer require shareholder approval. Third, criminal sanctions on "giving benefits in connection of exercise of shareholder rights" were strengthened (strengthening criminal sanctions of illegal payments to sokaiya).

Also, in 1997, a special statute providing companies with a liberalized procedure for redeeming their outstanding shares was passed. The Commercial Code requires a resolution of the shareholders meeting to redeem shares, and the redemption may only be made out of the company's retained earnings. This special statute liberalized the requirement: the redemption may be made by a resolution of the board, and the board may report the redemption to a subsequent shareholders meeting for approval. In 1998, the statute was amended to permit a company to redeem shares out of its capital surplus under certain conditions by a board resolution (this part of the statute was intended to expire at the end of March, 2000, but was extended to the end of March, 2002). In 1998, another special statute was enacted to allow a company to reevaluate its land so as to improve its balance sheet.

In 1999, a system of "share exchange" was introduced. This was in response to the abolishment of the prohibition upon holding companies in the Anti-Monopoly Act. Specifically, a share exchange is a mechanism for creating a parent company, and thus allowing an easier move to the structure of a holding company. For the purposes of an example, suppose that Listed Company X wants to create Holding Company H and become its 100% subsidiary by making H a listed company. Before the 1999 amendments, there was no easy way of accomplishing this goal. Now, X can engage in a share exchange transaction, by which all shares of X are exchanged for shares of H upon a special resolution of the shareholders meeting of X. The resolution binds dissenting shareholders, whose only remedy is an appraisal right (the right to have the shares purchased by the company at a fair value). In connection with this, some amendments to enhance the protection of the shareholders of the parent company (including a holding company) were made, by strengthening disclosure requirements. Finally, important changes were made to recognize market value accounting under corporate law. This last change was in response to a change in accounting standards that requires public companies (known as "reporting companies" under securities law) to adopt market value accounting for their financial assets. The trend to adopt market value accounting is a result of the pressure from global trends, most notably, the standard setting at the International Accounting Standards Committee.

In 2000, a procedure for corporate divisions (known as Abspaltung in Germany) was introduced. Suppose that Company Y has a toy division and a movie division. Y now

can divide and put its toy division into a newly created or existing company, Z. The basis of the procedure is that once a special resolution is passed at the shareholders meeting, Y's toy division (which must constitute a business as such under the new corporate law) will be transferred to Z with all of the assets and liabilities that belong to the division, and there is no need to obtain the approval of the individual creditors of the debts being transferred. The creditors' only remedy is a right to collateral, as in mergers, and they cannot stop the process of division. A special companion statute was enacted to protect employees, requiring, among other things, that the company must consult with its employees in advance. Another point is that if Y transfers its division to Z by an "investment in kind", as a general rule in corporate law requires an inspection by a court-appointed examiner. However, a corporate division does not require this costly and time-consuming process. These amendments will become effective in April or May 2001.

Finally, in September 2000, the Legislative Council announced that it will consider further wide-scale changes to corporate law with a view to submitting a bill to the Diet in 2002. This reform plan includes very wide-ranging matters in the fields of corporate governance, corporate finance, accounting, matters related to information technology and rules in relation to foreign companies.

## **2. Characteristics of Corporate Law Reforms in Japan**

### **2.1. Speed**

One common characteristic that can be easily observed from the recent corporate law reforms is speed. Many important and large-scale reforms have been made quite quickly. This can be understood because speedy reforms are necessary for Japanese companies to survive the quickly changing environment of information technology and global competition.

### **2.2. Role of Politicians**

In the past, all reforms in corporate law were first considered carefully at the Legislative Council, Commercial Law Division, an advisory body to the Minister of Justice. It submitted a proposal, and bureaucrats at the Ministry of Justice prepared the bill. The bill was then submitted to the Diet by the Cabinet. While this is still the major way of corporate law reform today, it must be noted that another route has emerged: politicians (as members of the Diet) prepare and submit a bill to the Diet without going through the Cabinet. In fact, in the area of corporate law, the first bill since World War II to take such path was the introduction of the stock option system in the 1997 amendments to the Commercial Code. The special statutes on share redemption and reevaluation of land also took this form.

Underlying this new trend is the fact that the business community wanted a speedy change and approached politicians directly, rather than approaching the Legislative Council.

Also, the amendments to introduce corporate divisions were originally expected to be made in 2001. But the Panel on Industry Competitiveness at the Prime Minister's Office, comprised of the top business leaders of Japan, strongly requested prompt action, and the Ministry of Justice followed this request and passed the amendments in 2000.

Beginning 1995, the Subcommittee on Commercial Law at the Liberal Democratic Party has been considering large-scale amendments to shareholder derivative actions and the statutory auditor system. In September 2000, a project team was formed by the Three Ruling Parties and the team is discussing the proposal of the Liberal Democratic Party. The team is aiming at submitting a bill to the Diet in 2001. If this happens, rules directly relating to corporate governance will be amended on a large-scale as a result of a politician's, rather than the Cabinet's, initiative.

### **2.3. Special Legislation for New Businesses and Restructuring**

Another important trend is the passage of special statutes in the Diet. These statutes provide "authorized companies" with special favorable treatments in corporate law. While this first occurred more than ten years ago, two recent pieces of legislation are good examples of this phenomenon. The Act for Creating and Promoting New Businesses in 1998 (the "New Businesses Act") (the most recent change is effective from March 2000) is a statute that supports start-up, new businesses in Japan. Once a business obtains the authorization from the Ministry of International Trade and Industry ("MITI") under the New Businesses Act, it receives various benefits. In the area of corporate law, such businesses enjoy three special benefits. First, the general limitation that stock options can only be issued up to one-tenth of the total issued shares is expanded to one-third of the total issued shares of the companies to which the New Businesses Act applies. Under the Commercial Code stock options can only be issued to a company's directors and employees, but they can be issued to other parties under the New Businesses Act. Second, under general corporate law the amount of nonvoting preferred shares must be up to one-third of the total issued shares, but it is expanded to one half of the total issued shares under the New Businesses Act. Under general corporate law, such shareholders obtain voting rights after one year from when the preferred dividend is not paid, but after three years under this Act. Third, while "ex post incorporation" (transfer of property to a company within two years of its incorporation), like in-kind investment, requires inspection by a court-appointed examiner, this can be replaced with inspection by a CPA and others selected by the company.

The second statute, the Act for Special Measures for Rehabilitation of Industry Power (the "Rehabilitation Act"), which was passed in 1999, is legislation designed to facilitate the restructuring of large businesses. The Act was structured similarly. Once a business obtains the MITI's authorization under the Rehabilitation Act, it receives various benefits. In the area of corporate law, the following benefits apply: first, the inspection by a court-appointed examiner in relation to an investment in kind is excused. Second, the acquisition of an asset with the value of one-twentieth or less of the net worth of the acquiring company does not require shareholder approval. Third, certain transfers of debts accompanying a transfer of business do not require the individual consent of the creditors. Fourth, stock options, up to the half the total of the issued shares, can be issued to directors or employees of subsidiary companies. Fifth, nonvoting preferred stock of up to one half of the total issued shares can be issued.

It is anticipated that some of the benefits of these special statutes will be incorporated into the Commercial Code in the future. In fact, the second and third measures under the Rehabilitation Act were already recognized as general rules in the 2000 amendments to the Commercial Code. Other measures such as limitation of the

amount of nonvoting preferred stock, measures concerning stock options and liberalization of the inspection requirement with respect to in-kind investments are under consideration in the current program for further reform of corporate law at the Legislative Council.

## **2.4. Impact of Global Trends**

There is increased global discussion on corporate governance and corporate law reform today. For instance, the OECD and other organizations have been quite active in the debate of corporate governance in recent years. There is an abundance of empirical research on corporate governance, and the worldwide discussion on how corporate law should be improved has been led by these empirical studies. The basic belief (though yet unproven) is that corporate governance affects a company's performance and the country's economic performance, and that corporate law affects corporate governance. If these causal links exist, corporate law reform is more important than ever: it should be considered as one of the top policy matters for any country. However, in this respect, Japan has not yet been persuaded with the exception of market-value accounting. In contrast, reforms in the financial sector have been greatly affected by global discussion, and I believe that the time will soon come when corporate law reform in Japan will not be able to proceed without considering worldwide discussion and developments.

## **III. Some Responses to the "Issues Note"**

### **Session 2: Current Reform Initiatives – Challenges and Opportunities**

2.1 What are the main driving forces behind current company law reform initiatives? For example, what are the general influences from internationalisation, developments in financial markets, the emergence of new industries and the introduction of new communication and information technology? How are these influences manifested in reform work?

The driving forces seem to be rapidly changing business, economic and technological environments. Increased competition and expanded capital markets are also important. The reform work currently undertaken by the Legislative Council, Commercial Division, specifies four perspectives: ensuring the effectiveness of corporate governance, responding to the "information technology society," improvement of the means of corporate finance and responding to cross-border activities of corporations. The Legislative Council aims at submitting a bill for a wide-range reform of corporate law in the Diet in the spring of 2002. There are exceptions for this plan. First, a bill to change the settlement system of bonds and to dematerialize commercial papers is expected to be submitted to the Diet in the spring of 2001. Second, a reform bill on liberalizing the stock option system and permitting use of electronic means in various matters, such as voting at shareholders meetings and company's public notices, is expected to be submitted to the Diet in the fall of 2001. Also, a project team by the Diet members of the ruling parties may submit a bill to reform the statutory auditor system and the system of shareholder's derivative actions in 2001.

2.2 Are there any indications that current influences or demands on company law lead to international convergence in terms of the legal approach, and the legislative and regulatory content?

Yes and no. To a large extent, driving forces for corporate law reforms seem to be common among major countries. The actual contents of reform may vary from country to country, so that convergence may be functional, not suggesting that all jurisdictions will have the same corporate law rules.

2.3 To what extent are recent efforts to reform company law influenced by developments in related regulatory domains, notably securities legislation?

The developments and expansion of capital markets are important. There is an opinion that corporate law should be divided into two parts, one of which is for public companies subject to securities regulation and the other is for the rest. Also, current accounting regulation is dual for public companies (namely, reporting companies), and there is an opinion that disclosure regulation should be adjusted between securities regulation and corporate law, although the corporate law rule on dividend restrictions should be maintained.

2.4 To what extent is the impact on the functioning of the economy and corporate competitiveness explicitly considered in company law reform? If this is the case, how is this manifested in practice?

Competitiveness is important. All of the four perspectives above can be seen as those for helping corporations organized in Japan enhance competitiveness.

2.5 In your experience, what aspects of company law and its application tend to attract most interest from the business community? In a rapidly changing environment, how is the balance between predictability and flexibility handled? Is the promptness of the judicial process and dispute settlements considered an important factor?

The business community has been requesting liberalization on many matters: the stock option system, different classes of shares, accounting rules, share redemptions and repurchases, and use of electronic means. There is a large-scale program for reforming the judicial sector at the Cabinet, including a plan of increasing the number of lawyers.

2.6 To what extent is the relationship between statutory rules and self-regulation addressed in reform work? What do you consider to be the basic characteristics and indispensable elements of credible and effective self-regulation?

While the importance of self-regulation is acknowledged, current discussion on corporate law reforms generally does not look to it. In practice, however, the importance of listing rules by stock exchanges will probably increase in the future.

### **Session 3: The General Shareholders' Meeting**

3.1 Some commentators have argued that the existence of a large number of dispersed owners have made the traditional general shareholders' meeting obsolete and redundant. Would you agree with this?

Shareholders meetings in large public companies are somewhat ritual. But permitting use of electronic means in calling a meeting and voting may change the picture.

3.2 What are the main effects on the shareholder's meeting from an increasing number of shareholders and a more dispersed international ownership structure? Is it likely that such developments will change the role and the format of the shareholders' meeting?

There is an opinion that as shareholdings become more dispersed and international, the quorum requirement for a special resolution (one half of the total issued shares) might be too harsh. Some shareholders from outside Japan also have a request that the notice of a meeting (which must be sent two weeks in advance of the meeting) should be sent earlier enough for them to prepare.

3.3 How may new information technology be used to improve the functioning of the shareholders' meeting in terms of information dissemination, voting procedures (including proxies), etc.? Have any concrete steps been taken in this direction?

Not yet introduced. A reform bill is expected to be submitted to the Diet in the fall of 2001. Use of electronic means in sending the notice of a shareholders meeting (accompanying proxy statements) and shareholder voting will be recognized for shareholders who agree. There is also an opinion that a shareholders meeting should not have to be held physically, and it should be permitted to be held in a cyberspace.

3.4 How should the general competence of the shareholders' meeting be defined? Should it be designated to deal with a limited and defined set of issues or, as a principle, be able to serve as the ultimate decision making body on virtually all company matters? Is it possible to identify any shifts in responsibilities among different company organs, such as the shareholders' meeting, the board and executive management?

There is discussion on this point. Two matters under discussion that are, in current law, subject to the jurisdiction of the shareholders meeting are the determination of dividends and the determination of compensation (remuneration) of directors and auditors.

3.5 Under what circumstances should deviations from the simple majority rule be mandated? In your experience, what is the underlying reason and guiding principle for such deviations? Is there a real risk that super majority requirements in the case of dispersed ownership and low participation rates may stall the decision making process making it practically impossible to obtain the required majority?

Although the permissibility of (upward) deviations is a matter of interpretation of current corporate law, such deviations are not observed in practice in large companies. For closely held companies, there is an opinion that flexibility in providing matters in the company charter should be permitted.

3.6 What is generally law and practice when it comes to the nomination and election of the board of directors? What is the experience from nomination committees, cumulative voting rights and minority representation?

The board of directors recommends candidates of directors and auditors to the shareholders meeting. Nomination committees are rare in practice. Cumulative voting is also rare; the law provides it unless the charter provides otherwise, and charters in most companies opt it out. For startup, small companies, there is an opinion that different investors, such as common stockholders and preferred stockholders, should be given the

right to send their representative to the board, so that the current corporate law should be amended to permit this.

#### **Session 4: The Board of Directors**

4.1 In your experience, has the competence of the board as a company organ in any way changed in relation to the shareholders' meeting and executive management? Is the issue of one or two tier boards important or are the practical implications of the two approaches fairly similar? Can general principles of board practices and duties be applied regardless of the structure?

Large-size corporations have the two-tier board system: the board of directors and the board of statutory auditors. The system of statutory auditor is unique, and is described in Appendix A.

4.2 What should be the basic point of departure for policy-makers when regulating issues related to board duties? Is it sufficient to define these duties for the board *as such* making its members subject to uniform fiduciary duties regardless of their background, affiliation or "electorate"? Or, is it necessary to go beyond that and legislate on additional "safeguards", for example in terms of the board's size, composition and routines? Is it meaningful to legislate on such matters as age, number of board engagements and board member qualifications?

Each member of the board, as a director, owes the same level of fiduciary duty to the company. There is an opinion that the standard of the director's liability should be negligence (in current law, the strict liability standard is adopted for certain matters, such as illegally excessive dividends). There is no limitation on age or the number. There is a basic disqualification standard stipulated in law. There is a trend in practice that the number of board members decreases. A fair number of companies in recent years have created a status of "officers," although there is no specific rule in corporate law, and reduced the number of directors: typically from 30 to 10. Their explanations vary, but the most common one is to effectuate the separation between strategic decision-making and implementation.

4.3 What is the general trend in terms of the board's fiduciary duties: to shareholders or the company?

To the company.

4.4 What is your experience from different approaches to the nomination and election of board members? From society's perspective, do nomination committees have advantages that should make the use of such committees compulsory? What are the main advantages and disadvantages of cumulative voting rights?

There is no enthusiasm about nomination committees in Japan. They are rare in practice. There is almost no opinion to advocate mandating cumulative voting.

4.5 What can be said about independent board members? How is this term generally defined? Does it typically include independence from large owners? Should the potential problem of "dependence" be solved by mandating independent directors or by strengthening compliance with stated and uniform fiduciary duties for all board members?

Some companies have independent directors, but such practice is not very common. In large-size companies, there must be at least one independent statutory auditor, and he/she must be a person who has not been the director or employee of the company or its subsidiaries for five years prior to appointment as an auditor. See Appendix A.

4.6 What can be said about different approaches to board remuneration and the decisions on remuneration of board members? Is there any scope for legislation or to advocate certain forms of remuneration over other? Should disclosure of board remuneration be an issue for legislation?

Under the current law, board members remuneration must be set at the shareholders meeting or in the charter, although only the total amount of the remuneration of all directors has to be decided. Remuneration of directors and that of auditors must be set separately. There is an opinion that individual amounts of director remuneration should be disclosed; this view may obtain support if the determination of remuneration is made by the board, rather than the shareholders meeting.

### **Session 6: The Capital Structure of the Company**

6.1 To what extent can developments in terms of financial innovations and financing techniques be expected to influence company law and related regulatory domains? Can you provide examples of how legislation has been changed in order to facilitate for the company and its capital suppliers to arrive at more cost-effective capital structures?

As noted in Section I, the history of amendments to corporate law in the area of corporate finance is the history of deregulation, which has given companies flexibility in financing. Currently, there is an opinion that rules on different classes of shares should be liberalized.

6.2 What aspects of “minority” or third party protection do you consider to be most topical in relation to adjustments of the capital structure? What should be the “guiding principle” for “equal treatment” in relation to adjustments in the capital structure? What are the experiences from preemptive rights and directed buy-backs?

Problems regarding different classes of shares are, under current law, dealt with by charter provisions and/or resolutions of shareholders of the same class. Within the same class, and typically for holders of common shares, equal treatment is not required for new issuance of shares if the price is fair, but is required in buy-backs. In public companies, buy-backs must be from the market or by a tender offer; buy-backs from certain shareholders are prohibited even if the price is fair. For buy-backs, corporate law imposes restrictions from the perspective of creditor protection.

6.3 Is court supervision necessary in capital reductions? Is it sufficient to focus on company solvency in relation to shareholder and creditor protection when changes to capital are being made?

No court supervision is necessary. An extraordinary resolution of the shareholders meeting and the procedure of creditor protection are required. Creditors cannot stop the reduction, but can submit an objection. If an objection is made from a creditor, the company must pay or provide collateral.

6.4 How does your legislation view the relationship between dividends, share buy-backs and redemption of shares? Does legislation generally discriminate between these different approaches to distribution? What influences the company's choice of technique?

Generally speaking, these three are all subject to the same restrictions on distributions, although the exact rules are highly complex and permit certain differences among them. Right now (until the end of March 2002), share redemptions may be made out of the company's capital surplus, to the extent that the amount of the capital surplus and the earnings surplus exceeds one-fourth of the amount of the legal capital.

6.5 Particularly in listed companies, what are the main merits and disadvantages of a legal capital requirement?

Not much discussed.

6.6 To what extent does legislation concerning the capital structure explicitly consider its impact on the governance and control structure of the company?

Not much discussed in general. See above 3.6 for reform proposals for startup, small businesses.

## **Session 7: Corporate Ownership and Control**

7.1 What can be considered a reasonable level of disclosure of individual shareholdings? In your view, what are the most effective procedures and mechanisms for such disclosure?

The Securities and Exchange Act requires disclosure when a shareholder obtains more than 5% of shares of a reporting company.

7.2 What are the legal requirements for disclosure of other control mechanisms than direct ownership, for example cross-shareholdings, company groups, voting caps, shareholder's agreements, etc.?

The rule on cross-shareholding is not tight: if Company A owns more than 25% of the total issued shares of Company B, B is prohibited from exercising the voting right in A. If A owns more than 50% of the shares of B, in addition to voting prohibition, B is prohibited from purchasing A's shares except for certain limited situations stipulated by law. The rules on company groups are not many in Japan insofar as statutory rules are concerned. Voting caps are not permitted. Shareholder's agreements are generally considered as void if they are in conflict with mandatory provisions of corporate law, although they may be valid in contract law. There is an opinion for reform of the current corporate law that shareholder's agreements should be generally permitted in close companies.

7.3 What are the most critical legal provisions that need to be in place in order to assure free and cost-effective transferability of shares?

The current law strongly guarantees free transferability of shares. The restriction on transferability must comply with the statutory provision, which regulates the permissible form of restriction: the restriction must be written in the charter and in the way that the

board of directors approval is required. Even in this case, if the board does not approve, it must designate a party who buys the share.

7.4 Equal treatment is often considered a central principle during changes in corporate control. How is this principle manifested in law or regulations?

Not easy to answer. The issue should be considered in each situation in question. Japanese corporate law emphasizes equal treatment: for example, the principle of one share, one vote is strict.

7.5 What are the merits and disadvantages of a mandatory bid rule? If your country has such a rule, how is the principle of equal (or fair) treatment manifested?

There is no mandatory bid rule in Japan. Tender offer regulation is similar to that in the U.S.

7.6 Is the board of directors in the target-company generally expected to take an active role during the take-over process? Should executive managers and the board of directors have any legal rights to impose obstacles to changes in corporate control? What would motivate any such rights or obligations?

Tender offer regulation under securities law ensures a fair and transparent process. In corporate law, managers do not have many means of defence. Issuing new shares to third parties is probably the only means of effective defence. There are very few hostile takeover attempts in Japan.

## **Appendix A: The Statutory Auditor System in Japan**

### **Overview**

Under the Commercial Code of Japan ("the Code"), a statutory auditor (kansayaku) (hereinafter "auditor") is a mandatory organ of a joint-stock company. The auditor system existed before World War II, but the amendments to the Code in 1950 reduced the power and responsibility of auditors. The system took its current form by the amendments to the Code in 1974, 1981, and 1993, which strengthened the power and independence of auditors.

Auditors are elected at the shareholders' meeting, and their role is to "audit" the activities of directors. This audit includes both a "business audit" and a "financial audit." A business audit is a check on whether or not the directors are observing laws, regulations and the company's charter provisions in managing the company and is commonly called a "compliance audit." It is generally understood that this does not include a check on the appropriateness of a director's decision-making or activities (sometimes referred to as an "appropriateness audit"). However, since the Code imposes a duty of care upon directors, a business audit must include a check on whether or not there are any breaches of this duty of care, and therefore, the auditor must look at directors' business judgments from this perspective.

A financial audit is conducted before financial statements are submitted to a shareholders' annual meeting, and the audit report, which contains the results of the financial and business audits, must accompany the notice of the shareholders' meeting.

The auditor system is stricter in "large companies." A large company is defined in the statute as a joint-stock company having legal capital of 500 million yen or more or total balance-sheet liabilities of 20 billion yen or more, and there are approximately 9,000 large companies today. For such large companies, there must be at least three auditors, at least one of whom must be full-time, and there must be at least one "outside" auditor. A board of auditors must be formed. In view of the function it plays in large companies, a board of auditors can be viewed as similar to an audit committee in the United States. However, the board of auditors must be a separate body from the board of directors, and an auditor may not serve concurrently as a director. The Code's qualifications for outside auditors require even greater independence.

### **Election, Duty and Liability of Auditors**

#### **Election of Auditors**

Auditors are elected at the shareholders' meeting. A quorum may not be reduced to less than one third of the total number of issued shares (the same as for the election of directors). The Code provides disqualification reasons for auditors and directors, and an auditor may not serve concurrently as a director or employee of the company or its subsidiaries.

An auditor has the right to express opinions at the shareholders' meeting regarding the appointment of other auditors.

Each auditor serves a three-year term, as compared to two years for directors. This term cannot be

shortened by the charter. Compensation must be set in the charter or by a resolution at the shareholders' meeting, separately from the compensation for directors.

A large company must have a minimum of three auditors, and they must elect among themselves at least one full-time auditor. Also, at least one of them (termed the "outside" auditor) must not have been a director or employee of the company or its subsidiaries within the past five years prior to appointment. A board of auditors must be formed. Thus, in large companies, the Japanese board system is two-tiered, but it differs considerably from the German system. Rather, the Japanese board of auditors can be viewed as similar to the U.S. audit committee.

## **Duty of Auditors**

The legal relationship between an auditor and the company is entrustment (inin). Consequently, an auditor owes a duty of care to the company. Under the Code, the legal duty of an auditor is to "audit" the activities of directors, through a business audit and a financial audit. (The audit is limited to the latter in "small companies," but the situation for small companies is omitted in this memorandum.)

A business audit is a check on whether or not the directors are observing laws, regulations and the company's charter provisions in managing the company and is commonly called a "compliance audit." It is generally understood that this does not include a check on the appropriateness of a director's decision-making or activities (sometimes referred to as an "appropriateness audit"). However, since the Code imposes a duty of care upon directors, a business audit must include a check on whether or not there are any breaches of this duty of care, and therefore, the auditor must look at directors' business judgments from this perspective.

A financial audit is an audit of financial statements and, unlike an audit required under the Securities and Exchange Law, it must be conducted before the annual shareholders' meeting. The audit report, which contains the results of the financial and business audits, must accompany the notice of the annual shareholders' meeting and be sent to shareholders before two weeks prior to the meeting.

Auditors are given various powers and legal rights in order to carry out their duties.

### Right to obtain reports and conduct examinations

An auditor has the right to ask a director or employee to provide a report on the company's operations and the right to examine the operations and assets of the company at any time. If a director notices the possibility of significant damage occurring to the company, he or she must report this to the auditor even without being asked to do so. The auditor also has the legal right, under prescribed conditions, to ask for a report and examine the operations and assets of any of the company's subsidiaries. The company bears the expense of the audit (including examination).

### Prevention of directors' illegal action

An auditor has the right to attend board of directors' meetings and express opinions in order to prevent the board of directors from making illegal or significantly inappropriate decisions for the company. If an auditor notices a violation, or the possibility thereof, of law or the company's charter provisions by a director, he or she must report it to the board of directors. If necessary the auditor

may ask for a meeting of the board of directors to be called, or the auditor has the right to call a meeting him/herself. When such a decision or action violating law or the company's charter provisions cannot be prevented or rectified, if there is illegality or significant inappropriateness in the proposals or documents submitted by a director to the shareholders' meeting, the auditor must report his or her opinion at the shareholders' meeting. Moreover, if the auditor finds out an inappropriate act or a significant violation of law or the company's charter provisions, this must be written in the audit report. If there is a possibility that the director's action in violation of law or the charter provisions will cause considerable damage to the company, the auditor has the right to ask the director to stop the action. Also, the auditor has standing to sue for the nullification of a shareholders' meeting.

### Litigation between the company and its directors

In litigation between a company and its director, the auditor represents the company. Accordingly, it is the auditor who makes the decision about whether the company will sue a director. It is also the auditor to whom a "demand" is submitted in a shareholder derivative action.

### Financial audit

A financial audit is an audit of financial statements and their appendices. A large company must appoint a CPA or auditing firm as an external financial auditor. The external financial auditor is elected at the shareholders' meeting, and the election proposal must be approved by the auditors in advance. Accordingly, a financial audit in large companies is undertaken primarily by the external financial auditor, and this financial auditor's report is submitted to the board of auditors and the board of directors. The auditors check the appropriateness of a summary of the process and of the results of the financial auditor's auditing. If the auditor believes that either is inappropriate, he or she must state so with reasons in the audit report and undertake an audit by him/herself and describe a summary of the process and the result of such audit in the audit report. If the financial auditor uncovers an inappropriate act or a violation of law or the company's charter provisions in connection with directors' activities, it must report it to the board of auditors. An auditor also has the right to ask the financial auditor for a report if necessary. With all of the above, in large companies, the auditors are responsible for monitoring and managing the external financial audit, as is the case with the audit committee in the United States. The audit report accompanies the notice of the annual shareholders' meeting and includes the results of the financial and business audits. In large companies, this audit report is prepared by the board of auditors, but each auditor has the right to write his or her own opinion.

### **Liability of Auditors**

Under the Code, if there is a breach of an auditor's duty of care owed to the company, the auditor is liable to the company for damages. In addition, if there is bad faith or gross negligence in the audit activity, or if the audit report contains a false statement, the auditor may be liable directly to a third party for damages.

## Appendix 2

### Number of Companies in Japan

Type	Amount of Legal Capital	Number	%
Kabushikigaisha (joint stock company)	less than 50 million	1,121,000	36.9
	50 million yen or more and less than 100 million yen	53,000	1.8
	100 million yen or more and less than 500 million yen	30,000	1.0
	500 million yen or more	10,000	0.3
<b>SUBTOTAL</b>		1,214,000	40.0
Gomeigaisha (incorporated partnership)		19,000	0.6
Goshigaisha (incorporated limited partnership)		82,000	2.7
Yugengaisha (limited liability company)		1,723,000	56.7
<b>TOTAL</b>		3,038,000	100.0

As of November 30, 2000

Source: Ministry of Justice

Note: numbers of kumiai (partnership) and tokumeikumiai (limited partnership) are not available.