

ASIA

Japanese Companies Act changes encourage investment

By Jeff Schrepfer and Satoko Kametaka

The enactment of the Companies Act of Japan in 2006 was a once-in-a-century revolution for Japanese company legislation. It was the modernization of Japanese corporate law through a complete rewrite and consolidation of multiple laws into a single piece of legislation. Next spring, the Companies Act is scheduled to undergo its first set of amendments since its inception. One of the main goals of these amendments is to encourage more investment in Japan by strengthening the corporate governance regime and by facilitating certain transactions that are cumbersome to achieve under current law. There are several key changes.

Outside Directors: Comply or Explain

Today, approximately three-quarters of companies listed on the first section of the Tokyo Stock Exchange have at least one outside director, which is a significant increase from 2010, when it was fewer than half. It is believed that media coverage of foreign investors criticizing the low adoption rate of outside directors in Japan and a subsequent amendment of the stock exchange rules that required listed companies to "make an effort" to appoint an independent director have both played a role in this increase.

After a prolonged debate about whether to amend the act to require companies to appoint outside directors, it has been agreed for now that listed companies will either have to appoint at least one outside director or explain at its general meeting of shareholders and in its annual business report why it is not appropriate to do so. Although not the mandatory requirement that many were hoping for, critics can take some comfort in the fact that a provision has also been included in the supplementary law regarding the amendment specifying that, two years after enactment of the amended act, the government must reevaluate the corporate governance regime in light of the adoption rate of outside directors and the social and economic situation and, if deemed necessary, it may implement measures to make the appointment of outside directors mandatory.

Encouraging Appointment of Outside Directors via Corporate Governance

Another way that the amended act will encourage the appointment of outside directors is by introducing a new corporate governance structure. Under the current law, there are two basic types of corporate governance structures that listed companies can choose from.

The traditional structure, which does

not require the appointment of outside directors, is to appoint a board of statutory auditors consisting of non-directors who monitor the board.

The other, which was introduced in 2003, is to have three committees — a nomination committee, a remuneration committee, and an auditing committee — in addition to the board of directors,

The main goals of these amendments is to encourage more investment in Japan by strengthening the corporate governance regime and by facilitating certain transactions that are cumbersome to achieve under current law.

with a majority of the members of each committee consisting of outside directors. However, only about 2 percent of companies listed on the Tokyo Stock Exchange have adopted the committee structure to date. Not surprisingly, it seems that many boards have been reluctant to delegate powers over the selection and remuneration of its directors to committees that are controlled by outside directors. On the other hand, investors have long been skeptical of the effectiveness of boards of statutory auditors, as statutory auditors do not have a vote on the board of directors.

In light of this, a new third option will be introduced, which is to have just one committee — an auditing committee — in lieu of the board of statutory auditors. A majority of the members of the auditing committee will have to be outside directors, and it will be given a certain degree of independence and power, but it will not have the power to nominate directors or decide their remuneration. It is anticipated that the introduction of this new alternative structure will help accelerate an increase in the number of outside directors on the boards of listed companies.

Injunctive Relief for M&A and Cash-Out Procedures

Under the current act, most mergers, corporate splits, cash-out procedures and other reorganization methods can only be challenged through post-facto annulment litigation. Considering the potential adverse effects of unwinding a transaction, shareholders and courts have been reluctant to take such drastic measures. However, the new amendments will allow shareholders to bring claims for injunctive relief prior to almost all types of reorganizations and cash-out

procedures in the event there is a violation of law or a breach of the company's articles of association and the shareholders can show that such violation or breach is prejudicial.

Derivative Suits by Parent Shareholders

Ever since the ban on holding companies in Japan was lifted in the late 1990s, the number of holding companies has steadily increased. For example, 17 Japanese holding companies have one or more banks as subsidiaries and 10 holding companies have one or more insurance companies as subsidiaries. However, an unintended consequence of permitting the use of holding companies is that they can be used as a shield against shareholder derivative suits for breaches of fiduciary duty by directors of the operating subsidiaries.

To respond to this limitation, the act will be amended to allow a shareholder of an ultimate parent company that directly or indirectly owns all the shares of a company to conduct a derivative suit against such company or its directors, provided that such company accounts for more than one-fifth of the book value of the parent company and such shareholder has held one percent or more of the shares of the parent company in terms of either voting rights or number of shares for the past six months.

Limitations on Changes of Control Through Dilution

Under the proposed amendments, if a capital injection will result in a new shareholder becoming the owner of a majority of the voting rights in a company, such fact must be disclosed to the company's existing shareholders in advance, and if 10 percent or more of them object, an ordinary resolution at a meeting of the shareholders will be required to approve the capital injection. This change comes after widespread criticism of significant third-party allotments that have been completed behind closed doors with board approval only.

Faster Cash-Out Procedure

Cash-out procedures under the current law are convoluted, time-consuming and costly. In recent years, the standard method in a going-private deal has been to use class shares with call options, which involves numerous technical steps, such as the convocation of a shareholders' meeting, reissuance of shares, intentional creation of fractional shares and a court approval. When class shares with call options were introduced in 2006, they were not intended to be utilized in this way, but they soon became

a popular method of squeezing out minority shareholders.

The amendments next spring will significantly improve the situation by introducing a new cash-out scheme. Under the new method, a shareholder with 90 percent or more of the voting rights in a company will be able to directly acquire the remaining shares, as well as any stock options held by the minority shareholders and option holders, by obtaining the approval of the target's board, but without having to obtain approval of the shareholders. Thus, a shareholder who successfully acquires at least 90 percent of a listed company through a tender offer will be able to take the company private with the approval of the board only, which should not be difficult in an amicable tender offer (as virtually all tender offers in Japan are).

In a world where capital flows across borders as easily as people, and countries increasingly find themselves competing for limited investment capital, countries inevitably find themselves in competition with one another regarding things like the sophistication and efficiency of their corporate law regimes. The amendments next spring will be an important step for Japan in responding to various criticisms from foreign and domestic investors since the Companies Act was passed in 2006 and will help it remain competitive with the rest of the world, which is a critical component of Prime Minister Abe's efforts to revitalize the Japanese economy by encouraging investment.

Jeff Schrepfer is a partner in the Corporate Department of the Tokyo office of Morrison & Foerster LLP. His practice focuses on cross-border mergers and acquisitions and

general corporate counseling for publicly and privately held companies.



JEFF SCHREPFER
Morrison & Foerster

Satoko Kametaka, an associate of Ito & Mitomi, has experience in providing legal advice on a wide range of domestic and international matters, including M&A, private equity, financing transactions such as acquisition finance and general corporate matters.



SATOKO KAMETAKA
Morrison & Foerster