The Future of Japanese Corporate Governance: The 2005 Reform

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I. INTRODUCTION

Since 2002, in Japan, the Working Group on Company Law (Modernization of Company Law) (*Kaisha-hô [Gendai-ka Kankei] Bukai*) of the Legislative Council (*Hôsei Shingi-kai*; the consultative body of the Ministry of Justice) has led a drastic reform of the company law – including Part II of the Commercial Code;[1] the Limited Liability Company Law;[2] and the Law of Exceptional Provisions to the Commercial Code Concerning the Audit, etc., of Stock Companies (hereinafter: Exceptional Provisions).[3] The Working Group published the results of their discussions as *kaisha hôsei no gendai-ka ni kansuru yôkô* (The Final Draft on the Modernization of the Company Law; hereinafter: Final Draft)[4] in February 2005. Based on the Final Draft, the Working Group prepared *kaisha-hô-an* (Company Code Bill; hereinafter: Company Code),[5] and submitted it to the Diet in March 2005. The Diet passed the Company Code with a few amendments on 29 June 2005.[6] The discussion in this article is based on the Company Code amended and approved by the Diet.

Since 2001, the company law has been reformed according to the following policies: (i) securing the realization of corporate governance; (ii) bringing the law into line with the highly-developed information society; (iii) improving fundraising measures; (iv) bringing the company law into line with the internationalization of corporate activity; and (v) modernizing terms and consolidating the company law. The 2005 reform is the culmination of a series of reforms in 2001 and 2002.[7]

According to the Final Draft, one of the fundamental aims of the 2005 reform is to establish an intelligible company law. Specifically, to modernize the old language – in use since the original enactment of the Commercial Code in the Meiji era; to arrange terms and clarify interpretations; and to consolidate the laws relating to companies (Part II of the Commercial Code; the Limited Liability Company Law; and the Exceptional Provisions) into *kaisha-hô* (Company Code).[8] The other fundamental aim is to review and adjust the whole of the company law, which has been reformed frequently, in order to bring it into line with the current social situation.[9] Although the 2005 reform

1 *Shôhô*, Law No. 48/1899, as amended by Law No. 154/2004.

2 *Yûgen kaisha-hô*, Law No. 74/1938, as amended by Law No. 88/2004.

3 *Kabushiki kaisha no kansa-tô ni kansuru shôhô no tokurei ni kansuru hôritsu*, Law No. 22/1974, as amended by Law No. 87/2004.

4 Available on the Ministry of Justice website: <*http://www.moj.go.jp/SHINGI/050209-1.html*>.

5 Reported in: Shôji Hômu 1727 (2005); available on the Ministry of Justice website: <*http://www.moj.go.jp/HOUAN/houan31.html*>.

6 The new Company Code will be enacted in April 2006.

7 K. EGASHIRA ET AL., *Kaisha hôsei no gendai-ka ni kansuru yôkô-shian wo megutte* [A Discussion of The Tentative Draft on the Modernization of the Company Law], in: Shôji Hômu 1685 (2004) 8 (quoting T. Aizawa). In relation to the 2001-2002 reforms, see Jurisuto 1206 (2001) 6-262; M. SHISEKI, *Heisei 14-nen kaisei shôhô no kaisetsu* [I]-[XI] [An Explanation of the 2002 Reform of the Commercial Code], in: Shôji Hômu 1636 (2002) 6-18; 1638 (2002) 24-31; 1639 (2002) 13-18; 1640 (2002) 4-10; 1641 (2002) 16-28; 1642 (2002) 19-26; 1643 (2002) 18-25; 1644 (2002) 15-22; 1646 (2002) 4-9; 1649 (2002) 4-13; 1650 (2002) 10-18.

8 Final Draft Part 1 Chap. 1, 1-3 (2004).

9 See Final Draft Part 1 Chap. 2.

covers the whole company law field, this article focuses on reforms to the structure of stock companies and, within that field, discusses those issues of corporate governance that are important in terms of comparative law.

II. CORPORATE GOVERNANCE STRUCTURE

1. *Existing Law*

The current company law requires all companies to have at least a shareholders' meeting and a board of directors. The shareholders' meeting appoints the directors (Art. 254 Commercial Code). The Japanese company law provides two kinds of governance structure models. One is the "Company with Committees",[10] the other is the "Company with a Corporate Auditor".[11] The corporate governance structure, except for the shareholders' meeting and the board of directors, differs between a Company with Committees and a Company with a Corporate Auditor. Furthermore, the Exceptional Provisions provide different auditing system rules depending on the size of the company.

A Company with a Corporate Auditor must have at least one representative director and one corporate auditor. The board of directors decides how the affairs of the company are to be administered (Art. 260 Commercial Code). The board of directors must appoint a representative director, who legally represents the company (Art. 261 Commercial Code), and may optionally appoint executive directors (Art. 260 para. 3 no. 2 Commercial Code). The representative director and executive directors execute the affairs of the company (Art. 260 para. 3 Commercial Code), under the supervision of the board of directors. The corporate auditor is appointed by the shareholders' meeting (Art. 280 Commercial Code) and their role differs depending on the size of the company. The Exceptional Provisions classify stock companies into "Large Company" (*dai-kaisha*),[12] "Small Company" (*shô-kaisha*),[13] and "other" (referred to as "Medium-

10 In Japanese this is called *i'inkai-tô secchi kaisha*. The Company with Committees system was introduced in 2002. The new law refers to it as *iinkai secchi kaisha* (Art. 2 no. 12 Company Code).

11 In Japanese this is called *kansayaku secchi kaisha.*

12 A "Large Company" is a stock company with stated capital of 500 million yen (around 3.65 million €) or more, or a stock company with a stated total amount of 20 billion yen (around 146 million €) or more in the liability section of its latest balance sheet (Art. 1-2 para. 1 Exceptional Provisions). "Large Company" is also defined in the new law (Art. 2 no. 6 Company Code).

13 A "Small Company" is a stock company with stated capital of 100 million yen (around 730000 €) or less (except stock companies with a total stated liability of 20 billion yen (around 146 million €) or more; Art. 1-2 para. 2 Exceptional Provisions). "Small Company" is not defined in the new law.

Sized Company" (*chû-kaisha*).[14] The Exceptional Provisions do not apply to Medium-Sized Companies. The strict regulations on the auditing system contained in the Exceptional Provisions are applied to Large Companies because they usually have many shareholders, creditors, employees and other stakeholders, and their financial statements can be complicated.[15] For example, a Large Company is required to be audited by its accounting auditors in addition to the audit by its corporate auditors,[16] and stricter requirements for appointing corporate auditors are imposed. A stock company with stated capital exceeding 100 million yen (about 730 000 €) can be subject to the same regulations as Large Companies if the company so provides in its articles of incorporation, in which case the company is regarded as a Large Company (*minashi dai-kaisha*; hereinafter: Constructive Large Company) (Art. 1-2 para. 3 no. 2; Art. 2 para. 2 Exceptional Provisions). On the other hand, laxer regulations are applied to Small Companies.[17] A Large Company must have three or more corporate auditors who comprise the board of corporate auditors (Art. 18 Exceptional Provisions). The role of the board of corporate auditors is to audit both accounting and the directors' execution of affairs.[18] The accounting audit is related to the audit by the accounting auditors. On the other hand, the role of a corporate auditor in a Small Company is only to audit accounting (Art. 22 Exceptional Provisions). The role of a corporate auditor in a Medium-Sized Company is to audit both accounting and the directors' execution (Art. 274 Commercial Code). Therefore, the execution of affairs is controlled by both the board of directors and the corporate auditors in all but Small Companies.[19]

Thus, the system for Companies with a Corporate Auditor differs from the German two-tier system in which the shareholders' meeting appoints the members of the board of corporate auditors and the board of corporate auditors appoints the directors, and also

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14 In this article, we make a distinction between "Large Company", "Small Company" and "Medium-Sized Company", which refer to the terms defined in the law, and "large company", "small company" and "medium-sized company", which refer to those terms in their ordinary meaning. On a separate note: in the EU, the fourth Directive on company law regulates companies by classification according to net assets, net turnover and number of employees.

15 See Chap. 2 Exceptional Provisions.

16 An accounting auditor must be either a Certified Public Accountant or an incorporated accounting firm (Art. 4 para. 1 Exceptional Provisions). The accounting auditor must be appointed at a shareholders' meeting (Art. 3 para. 1 Exceptional Provisions).

17 See Chap. 3 Exceptional Provisions.

18 It is, however, the accounting auditor who fulfills the main role in auditing the accounts in a Large Company.

19 It is thought that the board of directors supervises the execution of affairs from the viewpoint of "appropriateness" whereas corporate auditors audit it from the viewpoint of "legitimacy". M. KITAMURA, *Kabushiki kaisha ni okeru keiei kanri kikô kaikaku – Kakushu i'inkai seido wo chûshin ni* [The Reform of Corporate Management Structure], in: Osaka-shi Ritsu Daigaku Hôgaku Zasshi 48-4 (2002) 301.

from the one-tier system in which the shareholders' meeting appoints the executive officers.[20]

In addition to the Company with a Corporate Auditor system, the one-tier Company with Committees system was introduced into Japanese company law in 2002. The introduction of this system was aimed at increasing the international competitiveness of Japanese companies and providing companies with another corporate structure option in order to improve corporate governance.[21] This system works alongside the Company with a Corporate Auditor system, and Large Companies and Constructive Large Companies[22] may choose either system.

In a Company with Committees, execution and supervision are more clearly separated than in a Company with a Corporate Auditor. Companies with Committees cannot have any corporate auditors. Instead, the Company with Committees is required to have three committees (a nominating committee, an audit committee, and a compensation committee) and one or more executive officers (Art. 21-5 para. 1 Exceptional Provisions).[23] The members of each committee are appointed by the board of directors (Art. 21-8 para. 5 Exceptional Provisions). Each committee must consist of three or more directors, and a majority of the members of each committee must be "outside directors"[24] who are not executive officers of the company (Art. 21- 8 para. 4 Exceptional Provisions). The affairs of the company are executed by the executive officers and the company is legally represented by a representative executive officer.[25] The executive officers are appointed by the board of directors (Art. 21-13 para. 1 Exceptional

20 For the background of such corporate structure in Japan, see T. MIYAJIMA, *Kansa kikô* [The Mechanism of Audit], in: *Iwasaki Ryô Sensei tsuitô kinen rombun-shû: shôwa shôhô gakushi* [The History of the Commercial Code in the Showa Era] (Tokyo 1996) 391.

21 M. SHISEKI, *Heisei 14-nen kaisei shôhô no kaisetsu* [V] [An Explanation of the 2002 Reform of the Commercial Code [5]], in: Shôji Hômu 1641 (2002) 16, 20. It is expected that giving companies two options will lead to competition between the two systems and therefore improve corporate governance. K. EGASHIRA, *Kabushiki kaisha yûgen kaisha-hô* [Regulations of Stock Corporations and Limited Liability Companies] (4th ed. Tokyo 2005) 279. For the actual conditions on a company's choice, see E. TAKAHASHI / T. SAKAMOTO, The Reform of Corporate Governance in Japan: A Report on the Current Situation, in: The Journal of Interdisciplinary Economics 14 (2003) 193-197.

22 Only Large Companies and Constructive Large Companies are permitted to adopt the Company with Committees system (Art. 1-2. para. 3 Exceptional Provisions).

23 A company cannot have only one or two of these three committees, and cannot have both an executive officer and a representative director or both a corporate auditor and the audit committee.

24 An "outside director" is defined in the Commercial Code as a director who does not execute the affairs of the company; who in the past has never occupied the position of director, executive officer, manager, or any other employee who executes the affairs of the company or its subsidiaries; and is not a manager or any other employee of the company or its subsidiaries.

25 When a company has more than one executive officer, the representative officer is selected by the board of directors (Art. 21-15 para. 1 Exceptional Provisions).

Provisions). One role of the board of directors is to supervise such matters as the appointment of directors and executive officers, and make decisions on basic matters of management (see Art. 21-7 para. 1 Exceptional Provisions). The executive officers decide almost all matters of management (see Art. 21-7 para. 3, Art. 21-12 Exceptional Provisions). Therefore, decision-making is faster in a Company with Committees than in a Company with a Corporate Auditor.

The governance systems mentioned above are suitable mainly for large publicly-held companies. For small closely-held companies, the Limited Liability Company Law – enacted in 1938 – provides a form of corporation with a simple corporate structure.[26] In practice, however, a number of small-sized companies take the form of a stock company. Consequently, the majority of stock companies are closely-held companies,[27] and the same regulations as for the large-sized companies mentioned above also apply to these small-sized companies. Therefore, such companies encounter discrepancies between the regulations and their actual economic conditions.

2. Flexibility for Designing Corporate Governance Structure under the New Law

The improvements in corporate governance that we have so far addressed are for large publicly-held companies. One of the aims of the 2005 reform is a drastic review of the regulations for closely-held companies, which have so far only been partially reformed.[28] Efforts toward providing appropriate regulations for closely-held companies can be seen in the recent reform of company law in the United Kingdom.[29] Also, in the United States, the corporations code of each state has a special chapter[30] or exceptional provisions[31] for closely-held corporations.

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26 The limited liability company, a special form for closely-held companies, is a continental law system (EGASHIRA, *supra* note 21, 3). This form of company originated in Germany at the end of the 19th century and the Limited Liability Company Law in Japan originated from the German law.

27 T. SAKAMAKI, *Kabushiki kaisha kubun rippô no mondai-ten* [Problems with Separating Regulations of Stock Companies], in: Hanrei Taimuzu 1158 (2004) 46, 48.

28 Since the Commercial Code permits a stock company to restrict the transfer of its shares by providing in its articles of incorporation that the authorization by the board of directors is required, regulations suited to closely-held companies were partially introduced in 1966. See *e.g.* the proviso in Art. 166 para. 4; Art. 222 para. 1 no. 6; proviso in Art. 232 para. 1; Art. 280-5-2; Art. 280-27; Art. 341-5; proviso in Art. 347 Commercial Code.

29 COMPANY LAW REVIEW STEERING GROUP, Modern Company Law for a Competitive Economy – Final Report 1.53-1.55 (2001); Modernising Company Law, Cm 5553 1.2-1.7 (2002); DEPARTMENT OF TRADE AND INDUSTRY, Company Law Reform, Cm 6456 (2005) Chap. 4.

30 Del. Code. Ann. tit. 8 §§341-356.

31 Cal. Corp. Code. §§158, 300(b)-(e); NY Bus. Corp. Law §620(c).

In small closely-held companies, the ownership and management are not separated and each shareholder of the company can easily communicate with other shareholders. Thus, in these companies, the shareholders are able to control the management directly.[32] Therefore, these companies do not need a costly corporate management system such as a board of directors or corporate auditor. In any case, these companies are able to adopt the appropriate conditions for autonomy in their articles of incorporation – an expression of the shareholders' will. It is reasonable, and would help satisfy the shareholders' needs, to permit such companies to do this.[33] However, many provisions concerning corporate governance structure in the current company law are premised on the separation of ownership and management. The current company law therefore does not offer the most suitable regulations for small closely-held companies.

On the other hand, the Limited Liability Company Law, which provides a simple corporate structure, seems to offer more suitable regulations for small closely-held companies. The new law therefore attempts to unify (i) all the regulations for stock companies that provide in their articles of incorporation that the approval of the company is required before any class of issued stock can be transferred (*i.e.* stock companies not corresponding to *kôkai kaisha* [publicly-held company] as defined in Art. 2 no. 5 Company Code; hereinafter: Restricted Share-Transfer Companies); with (ii) the regulations for limited liability companies in the Limited Liability Company Law (Final Draft Part 2 Chap. 3, 1(2)). With regard to the corporate governance structure, the new law, referring to the regulations in the Limited Liability Company Law, (i) does not require a Restricted Share-Transfer Company to appoint a board of directors or a corporate auditor (see TABLE 1 below); (ii) permits autonomy through the articles of incorporation; and (iii) allows the shareholders' meeting to make decisions on any matter (this is explained in more detail in III.1. below).

However, there are some very large Restricted Share-Transfer Companies. Currently, there are many large closely-held companies with only one shareholder that have come about through the recent lifting of the ban on holding companies not in business; and the introduction of share exchanges,[34] stock transfers[35] and corporate divestiture[36].

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32 S. IWAHARA, *Kaisha kubun no arikata* [The Ideal Method of Classifying Companies], in: Jurisuto 1267 (2004) 35, 37.

33 Ibid.

34 *Kabushiki kôkan*. Arts. 352-361 Commercial Code; for provisions under the new law, see Arts. 767-771, 775-780, 782-792, 794-801 Company Code.

35 *Kabushiki iten*. Arts. 364-372 Commercial Code; for provisions under the new law, see Arts. 772-774, 803-812, 814-815 Company Code.

36 *Kaisha bunkatsu*. Arts. 373-374-31 Commercial Code; for provisions under the new law, see Arts. 757-766. HÔMUSHÔ MINJIBU SANJIKANSITSU, *Kaisha hôsei no gendai-ka ni kansuru yôkô shian hosoku setsumei* [Ministry of Justice Comments on the Tentative Draft of the Modernization of the Company Law] (hereinafter: Comments on Tentative Draft) Part 4 Chap. 1-1 (2003); available on the Ministry of Justice website: <*http://www.moj.go.jp/PUBLIC/MINJI39/pub_minji39.html*>.

As mentioned above, the Exceptional Provisions currently require all Large Companies to have an accounting auditor (Art. 2 para. 1 Exceptional Provisions) and to choose either the Company with Committees or the Company with a Corporate Auditor structure. These exceptional regulations exist for the protection of stakeholders, such as creditors of the company, and are based on a viewpoint different to that of separation of ownership and management. Hence, the new law requires all Large Companies[37] to have an accounting auditor and to choose either the Company with Committees or the Company with a Corporate Auditor structure, even if it is a Restricted Share-Transfer Company (Art. 328 Company Code).

Improvement on the regulations for the corporate governance structure of publicly-held companies was addressed in the 2001 and 2002 reforms,[38] and we should now observe the results of these reforms carefully.[39] The 2005 reform involves no substantial amendment of the structure of publicly-held companies and retains the competition between the Company with Committees and Company with a Corporate Auditor systems.

Under the new law, all stock companies are required to have a shareholders' meeting and a director (Final Draft Part 2 Chap. 3, 1(1); Art. 326 para. 1 Company Code). Under the rule in Arts. 326-328 of the Company Code, a company may optionally set up bodies such as the board of directors, a corporate auditor or a board of corporate auditors, *kaikei san'yo* (accounting consultant; this is explained in more detail in III.5. below), an accounting auditor, or the three committees (nominating committee, audit committee and compensation committee). The various possible options under the new law are shown in TABLE 1.

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37 *Dai-kaisha* ("Large Company"), under the new law, is defined in Art. 2 no. 6 Company Code.

38 For details, see M. SHISEKI, *Heisei 14-nen kaisei shôhô no kaisetsu* [V]-[IX] [An Explanation of the 2002 Reform of the Commercial Code [V]-[IX]], in: Shôji Hômu 1641 (2002) 16-28, 1642 (2002) 19-26, 1643 (2002) 18-25, 1644 (2002) 15-22, 1645 (2002) 4-9.

39 K. EGASHIRA, "*Gendai-ka" no kihon hôshin* [The Fundamental Policy of "Modernization"], in: Jurisuto 1267 (2004) 6, 10.

TABLE 1:[40] **Possible Designs for Corporate Governance Structure in Stock Companies under the New Law**

		Other types of companies (Medium-Sized Company / Small Company)		Large Company
		Without accounting auditor	***With accounting auditor***	***Compulsory accounting auditor***
Restricted Share-Transfer Company	***Without board of directors***	**(1)** Director **(2)** Director + corporate auditor **(3)** Director + accounting consultant **(4)** (2) + accounting consultant	**(1)** Director + corporate auditor **(2)** (1) + accounting consultant	**(1)** Director + corporate auditor **(2)** (1) + accounting consultant
Restricted Share-Transfer Company	***With board of directors***	**(5)** Board of directors + corporate auditor (or board of corporate auditors) **(6)** Board of directors + accounting consultant **(7)** (5) + accounting consultant	**(3)** Board of directors + corporate auditor (or board of corporate auditors) **(4)** Board of directors + committees **(5)** (3) + accounting consultant **(6)** (4) + accounting consultant	**(3)** Board of directors + corporate auditor (or board of corporate auditors) **(4)** Board of directors + committees **(5)** (3) + accounting consultant **(6)** (4) + accounting consultant
Publicly-held Company		**(i)** Board of directors + corporate auditor (or board of corporate auditors) **(ii)** (i) + accounting consultant	**(i)** Board of directors + corporate auditor (or board of corporate auditors) **(ii)** Board of directors + committees **(iii)** (i) + accounting consultant **(iv)** (ii) + accounting consultant	**(i)** Board of directors + corporate auditor (or board of corporate auditors) **(ii)** Board of directors + committees **(iii)** (i) + accounting consultant **(iv)** (ii) + accounting consultant

40 This table is based on: K. TAKEI, *Shin-kaisha-hô no jôbun kôzô* [The Structure of Provisions of the New Company Code], in: *Atarashii kaisha-hô zen-jôbun* [Complete Provisions of the New Company Code] (Tokyo 2005) 2.

- "Large Company" is defined in Art. 2 no. 6 Company Code.
- "Publicly-held Company" is defined in Art. 2 no. 5 Company Code.
- "Director" refers to where, under the new law, a company is permitted to have only one director (as with Restricted Share-Transfer Companies). In the case of a company without a board of directors, each director has powers of execution and representation of the company (Art. 348 para. 1 Company Code).
  In a company with a board of directors, the location of the power of execution and representation is the same as under the existing law (see Art. 261 Commercial Code; II.1 above).
- "Committees" = a nominating committee + an audit committee + a compensation committee + executive officer.
- Publicly-held companies, Companies with a Corporate Auditor (or board of corporate auditors) and Companies with Committees must have a board of directors (Art. 327 para. 1 Company Code).
- Companies with a board of directors must have a corporate auditor or committees, unless it is a Restricted Share-Transfer Company and has an accounting consultant (Art. 327 para. 2 Company Code).
- A company with an accounting auditor must have a corporate auditor (Art. 327 para. 3 Company Code).
- A Company with Committees must have an accounting auditor (Art. 327 para. 5 Company Code).
- A Large Company, which is neither a Restricted Share-Transfer Company nor a Company with Committees, must have a board of corporate auditors (Art. 328 para. 1 Company Code).
- A Large Company must have an accounting auditor (Art. 328 Company Code).
- A Company with Committees must not have a corporate auditor (Art. 327 para. 4 Company Code).

In a company which has neither a corporate auditor nor committees, it is necessary to strengthen the shareholders' direct control. The new law therefore provides the following rules. First, part of the corporate auditors' power to audit execution is given to the shareholders. Specifically, (i) shareholders are permitted to read the minutes of the board of directors without the permission of the court (Art. 371 para. 2 Company Code; *cf.* Art. 371 para. 3 Company Code, Art. 260-4 para. 6 Commercial Code), in the same way as corporate auditors; (ii) shareholders have the right to demand convocation of meetings of the board of directors in cases of directors' malfeasance or conduct outside corporate purposes (Art. 367 para. 1 Company Code); and (iii) shareholders who demand convocation can attend the meeting of the board of directors and present their opinions (Art. 367 para. 4 Company Code), as a corporate auditor can/must (Art. 385, Art. 383

Company Code). Second, the provision which permits a company to exempt a director from his/her liability through approval by a majority of directors or resolution of the board of directors (Art. 426 Company Code) does not apply to these companies. This is because the exemption of a director's liability by a majority of directors or by resolution of the board of directors requires the approval of each corporate auditor or each member of the auditing committee (Art. 426 para. 2 Company Code). Third, in these companies a director who has discovered a fact that is likely to cause significant damage to the company must immediately report it to the shareholders' meeting (Art. 357 para. 1 Company Code), while a director of another type of company in a similar position must report the fact to a corporate auditor (Art. 357 para. 2 Company Code). Finally, the requirements imposed on shareholders exercising their right to demand an injunction on directors' malfeasance in a company without a corporate auditor or committees (Art. 360 para. 1 Company Code) are less strict than those in a Company with a Corporate auditor or a Company with Committees (Art. 360 para. 3 Company Code).

III. Regulations on the Corporate Governance Structure of Restricted Share-Transfer Companies and Small-Sized Companies

1. *Number of Directors and Rights of the Shareholders' Meeting*

The new law attempts to realize a suitable corporate governance structure for Restricted Share-Transfer Companies. It provides such companies (assuming they do not have a board of directors) with the same structure model as limited liability companies, as described below.

First, such companies may have only one director under the new law whereas, under the existing law, all companies must have three or more directors (Final Draft Part 2 Chap. 3, 3(2)).

Second, the shareholders' meeting in companies without a board of directors can make decisions on all matters of the company (Art. 295 Company Code); whereas, under the existing law, the rights of the shareholders' meeting in all companies are limited to matters provided for in the Commercial Code or the company's articles of incorporation (Art. 230-10 Commercial Code).[41] The purpose of this limitation is to enable companies whose ownership and management are separated to bring directors' managerial abilities sufficiently into play and to clarify directors' liability for execution.[42] This is not suitable for Restricted Share-Transfer Companies in which the

41 This limitation is retained for companies with a board of directors: see Art. 295 para. 2 Company Code.

42 See K. Ueyanagi et al., *Shimpan chûshaku kaisha-hô* (5) [Annotated Company Law (5)] (Tokyo 1986) 19 (K. Egashira).

ownership and management do not seem to be separated and shareholders can control the management directly.

Third, several of the regulations on the shareholders' meeting have been modified (Final Draft Part 2 Chap. 3, 2(1) nos. 2-3). These modifications seem to be intended to allow the shareholders' meeting to be held more swiftly and to enable it to more effectively control management. For example, under the new law it is not necessary to mention or record the purpose of the shareholders' meeting in the convocation notice (see Art. 299 Company Code), whereas it is necessary under the existing law (Art. 232 para. 3 Commercial Code). This enables shareholders to make proposals on matters of management in a shareholders' meeting and to control management effectively and in a timely fashion.

Finally, in companies without a board of directors, items which would be decided by the board of directors under the existing law[43] will now be decided at the shareholders' meeting. For example, approval for the transfer of otherwise transfer-restricted shares (Art. 139 Company Code; *cf.* Art. 204 para. 1 Commercial Code), authorization of transactions involving directors' conflict of interest, and transactions involving directors in competition with the company (Art. 356 Company Code: *cf.* Art. 265, Art. 264 Commercial Code).

2. *Qualification of Directors*

Under the existing law, a stock company must not limit the persons qualified to be a director to shareholders of the company even if there is a provision permitting such limitation in its articles of incorporation (Art. 254 para. 2 Commercial Code). The purpose of this rule is to encourage companies to search widely for an appropriate person to fill the role of director. This rule is suited to publicly-held companies.[44] In contrast, the Limited Liability Company Law does not have such a rule. In closely-held companies, many of the shareholders prefer to participate in management as a director. This is because the management of medium or small-sized companies, and entrepreneurs in venture enterprises, often invest almost their entire fortune in these enterprises and therefore cannot make a living other than by engaging in the execution of the company's affairs and receiving remuneration.[45] Therefore, the new law does not apply this rule to Restricted Share-Transfer Companies, whether it has a board of directors or not (Art. 331 para. 2 Company Code).

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43 See EGASHIRA, *supra* note 21, 350-351.

44 Comments on Tentative Draft Part 4 Chap. 4, 2 (1); EGASHIRA, *supra* note 21, 338-339.

45 EGASHIRA, *supra* note 21, 279.

3. *Term of Office of Directors and Corporate Auditors*

The term of office of a director under the existing law may not, in principle, exceed 2 years (Art. 256 para. 1 Commercial Code).[46] The reason for this rule is that it is necessary to allow shareholders to frequently decide whether the present directors are competent because, under the existing law, the shareholders' meeting can make decisions on only a few basic matters and decisions on execution are left to the board of directors.[47] However, in order to reduce the costs of registration, the business world has sought to abolish the restriction or to extend the term of office for directors and corporate auditors in Restricted Share-Transfer Companies.[48] This would seem to be allowed because ownership and management are not separated in Restricted Share-Transfer Companies. The new law permits Restricted Share-Transfer Companies to extend the term of office to up to 10 years by providing as such in their articles of incorporation (Art. 332 para. 2 Company Code). This rule also applies to the term of office of a corporate auditor (Art. 336 para. 2 Company Code), which may not exceed 4 years under the existing law (Art. 273 para. 1 Commercial Code).

4. *Powers of Corporate Auditors*

As we mentioned above, under the existing law a corporate auditor in a Small Company has only the power to audit accounting (Art. 22 Exceptional Provisions), whereas a corporate auditor in any of the other companies has the power to audit execution as well (Art. 274 para. 1 Commercial Code). Under the new law, a corporate auditor in all types of companies has, in principle, the power to audit both accounting and execution (Art. 381 Company Code). However, to provide for the smooth adoption of this rule,[49] the new law allows Restricted Share-Transfer Companies to limit the power of a corporate auditor to the audit of accounting (Art. 389 Company Code). This exception does not apply to Restricted Share-Transfer Companies which have a board of corporate auditors or an accounting auditor (Art. 389 para. 1 Company Code).

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46 Art. 21-6 para. 1 Exceptional Provisions provides a different rule for Companies with Committees.

47 Comments on Tentative Draft Part 4 Chap. 4, 3.

48 Ibid.

49 HÔSEI SHINGI-KAI KAISHA-HÔ (GENDAI-KA KANKEI) BUKAI [Legislative Council Working Group on Company Law (Modernization)], Minutes No. 26 (2004) [hereinafter: Minutes No. 26]; available at <*http://www.moj.go.jp/SHINGI/index.html*>.

5. *Introduction of the Accounting Consultant*

In order to secure the fairness of financial statements, mainly in small or medium-sized companies, the new law introduces *kaikei san'yo* (accounting consultant).[50] This is a system which requires an accounting specialist to participate in preparing the financial statements of the company. An accounting consultant is an optional position in a company with the role of preparing financial statements (Art. 435 para. 2 Company Code) in conjunction with the directors or executive officers (Art. 374 para. 1 Company Code; Final Draft Part 2 Chap. 3, 5(3) no. 1). An accounting consultant must be a *zeiri-shi* (certified tax consultant; including incorporated tax consulting firms) or a chartered accountant (including incorporated accounting firms) (Art. 333 para. 1 Company Code). The new law allows either a certified tax consultant or a chartered accountant to be an accounting consultant in order to make it easier for small or medium-sized companies to employ an accounting consultant. Although this is a legal requirement under the new system, a number of companies at present actually have their financial statements prepared by a certified tax consultant or a chartered accountant. Thus, the introduction of an accounting consultant is based on current practice.[51]

Although the accounting consultant is being introduced mainly for small or medium-sized companies, large companies are not prevented from having an accounting consultant.[52] Any stock company can appoint an accounting consultant at the shareholders' meeting as long as there is a provision in its articles of incorporation so permitting (Art. 226 para. 2, Art. 329 para. 1 Company Code). The company must then register the name of the accounting consultant and the fact that it has an accounting consultant (Art. 911 para. 3 no. 16 Company Code).

Whereas an accounting audit is conducted by an outsider, an accounting consultant independently participates in preparing the financial statements as an internal officer of the company. Thus, the two offices differ and therefore a company can have both an accounting auditor and an accounting consultant (Final Draft Part 2 Chap. 3, 5(2) no. 2 (note)). However, in order to ensure independence, an accounting consultant is prohibited from being a director, executive officer, corporate auditor, accounting auditor, or an employee such as a manager in the company of which he/she is an accounting consultant, or in subsidiaries of that company (Art. 333 para. 3 no. 1 Company Code).

In addition to the company, an accounting consultant is also required to retain a copy of the financial statements (Art. 378 para. 1 Company Code). Shareholders and creditors of the company can demand that the accounting consultant show them the financial statements (Art. 378 para. 2 Company Code). This is not only convenient for the share-

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50 For a background to the introduction of the accounting consultant, see T. SAKAMAKI, *Kaikei sanyo seido no mondai-ten to kadai* [Problems and Issues in the Accounting Consultant System], in: Hanrei Taimuzu 1158 (2004) 84, 84-87.

51 Minutes No. 24.

52 Minutes No. 27.

holders or creditors of the company who wish to read the financial statements, but will also prevent fabrication and false alteration of the financial statements because the shareholders and creditors can compare the financial statements retained by the accounting consultant with those of the company. Moreover, an accounting consultant has a duty to explain any matters about which the shareholders query him/her (Art. 314 Company Code). An accounting consultant is liable to the company and third parties in the same way as an outside director (see Arts. 423-427, Arts. 429-430 of the Company Code), and shareholders can pursue this liability to the company through a shareholders' representative action (Art. 847 para. 1; Art. 423 para. 1 Company Code). It is sometimes argued that an accounting consultant should bear a stricter liability than an outside director because he/she is not a supervisor but an executor who personally participates in preparing the financial statements.[53] An accounting consultant is given the necessary rights to prepare financial statements (see Art. 374 paras. 2-3 Company Code).

The accounting consultants' participation in the preparation of the financial statements of a company will lead to those statements being more reliable. It is therefore expected that this will help to encourage transactions between financial institutions and small or medium-sized companies as well as protect the shareholders and creditors of the company.[54] Moreover, it is thought that the introduction of the accounting consultant may accelerate the unification of the many different accounting standards currently used in small and medium-sized companies.[55]

IV. Reform of Corporate Governance in Large-Sized Companies

1. *Decisions and Disclosure of the Internal Control System*

The execution of the affairs of a Company with Committees will be broad and complicated where the company is a Large Company or a Constructive Large Company.[56] In spite of this, under the existing law, Companies with Committees, unlike Companies with a Corporate Auditor, are not required to have a full-time director in the audit committee. Moreover, directors comprising the audit committee sometimes cannot, by themselves, sufficiently audit whether the company's affairs are being executed appropriately and efficiently. In order to ensure the effectiveness of the audit by the audit committee, the law requires the board of directors of a Company with Committees to decide on

53 Minutes No. 24; SAKAMAKI, *supra* note 50, 87.
54 Minutes No. 24.
55 SAKAMAKI, *supra* note 50, 93.
56 Under the existing law, only Large Companies and Constructive Large Companies are allowed to adopt the Company with Committees structure (Art. 1-2 para. 3 Exceptional Provisions).

a system for auditing whether the execution of the company's affairs complies with the law and the company's articles of incorporation, and whether this is being performed efficiently (this is known as the "internal control system"; Art. 21-7 para. 1 no. 2 Exceptional Provisions; Art. 193 Regulations for Enforcement of the Commercial Code[57]). The audit committee then uses this system to audit the execution.[58] An outline of the decisions of the internal control system must be entered into the business report of the company[59] and checked by the shareholders (Art. 104 para. 1 Regulations for Enforcement of the Commercial Code).

A district court has held, however, that directors of a Company with a Corporate Auditor also have a duty to establish an internal control system.[60] In any case, in relation to the requirement of establishing this system, there is no significant reason to distinguish between a Company with Committees and a Company with a Corporate Auditor, especially a large one. Therefore, the new law requires all Large Companies with a board of directors to decide on a basic plan for establishing the internal control system (Art. 362 para. 5 Company Code). Under the new law, the basic plan for establishing the internal control system must still be decided by the board of directors (Art. 362 para. 4 no. 6; Art. 416 para. 1 no. 1 Company Code) and the outline of the decision must be entered into the business report of the company (Final Draft Part 2 Chap. 3, 3(5) no. 1).

2. *Directors or Executive Officers who are Concurrently Employees in a Company with Committees*

Traditionally, there have been a number of directors in Japan who are concurrently employees of the company.[61] However, the purpose of the Company with Committees is to separate execution from supervision and to realize effectiveness and efficiency in the supervision of the execution. In light of this purpose, it is improper for a director who supervises executive officers to also be an employee directed by executive officers.[62] Therefore, the new law does not permit a director to concurrently be an em-

57 *Shôhô shikô kisoku*, Ministry of Justice Order No. 22/2002, as amended by Ministry of Justice Order No. 4/2005.

58 For details, see K. HAMA ET AL., *Heisei 14-nen shôhô kaisei ni tomonau kaisei shôhô shikô kisoku no kaisetsu* [V] [An Explanation of the Revised Regulations for Enforcement of the Commercial Code [V]], in: Shôji Hômu 1661 (2003) 19, 25-26.

59 The business report of a company is provided in Art. 281 Commercial Code.

60 Osaka District Court, September 20 2000, in: Hanrei Jihô 1721 (2000) 3.

61 T. OSUMI, *Torishimari-yaku no shiyônin kenmu no kôzai* [The Merits and Demerits of a Director who is Also a Company Employee], in: Shôji Hômu 755 (1976) 2; EGASHIRA, *supra* note 21, 338.

62 Comments on Tentative Draft Part 4 Chap. 4 10(1); H. MATSUI, *Kôporêto gabanansu* [Corporate Governance], in: Kigyô Kaikei 56-2 (2004) 44, 50.

ployee of the company (Art. 331 para. 3 Company Code). An employee must therefore resign his/her position if appointed a director of the company.

In contrast, under the existing law an executive officer is generally allowed to concurrently be an employee of the company. This is because a company's transition to the Company with Committees structure will be smoother if a prospective executive officer can retain his/her current office of employee.[63] This is also permitted under the new law.

In a Company with Committees, the executive officer's compensation package is decided by the compensation committee (Art. 21-8 para. 3; Art. 21-11 Exceptional Provisions). The "compensation", which is supervised by the compensation committee, has been interpreted, in the case of an executive officer who is concurrently an employee, to not include the employee salary.[64] Therefore, the employee salary of an executive officer is not controlled by the compensation committee. However, this is contrary to the purpose of the Company with Committees system.[65] Since their execution as an executive officer and their performance as an employee seem to be closely connected, the pay for such execution and performance should be controlled as a whole.[66] Thus, the new law provides that the employee salary of an executive officer who is concurrently an employee in a Company with Committees must be decided by the compensation committee (Art. 404 para. 3 Company Code).

V. ADJUSTMENT OF REGULATION DISCREPANCY BETWEEN COMPANIES WITH COMMITTEES AND COMPANIES WITH A CORPORATE AUDITOR

1. *Modification of Directors' Liability to the Company*

The new law attempts to address the difference in regulations for directors' liability between Companies with Committees and Companies with a Corporate Auditor.

The following directors' liabilities have been generally interpreted as *mu-kashitsu sekinin* (a strict liability in which a director is liable for damage to the company caused by his/her actions even if he/she acted without fault; hereinafter: strict liability):

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63 Except for this point, however, there is no practical use in permitting concurrence posts of executive officer and employee. Therefore, this should be permitted only as a transitional measure and should be forbidden in the future. S. MORIMOTO, *Dai-kaisha no kanri unei to kaisha hôsei no gendai-ka ni kansuru yôkô shian* [*Jô*] [Management of Large Companies and the Tentative Draft on the Modernization of the Company Law [1]], in: Shôji Hômu 1699 (2004) 4, 15 (n 23).

64 The Supreme Court held that with respect to a Company with a Corporate Auditor, the employee salary of a director who is concurrently an employee of the company is not subject to Art. 269 Commercial Code (which provides that a director's compensation must be decided by the shareholders' meeting) as long as a clear wage structure is established: Supreme Court, March 26 1985, in: Hanrei Jihô 1159 (1985) 150.

65 Comments on Tentative Draft Part 4 Chap. 4, 10(2).

66 MATSUI, *supra* note 62, 50.

liability for illegal dividends (Art. 266 para. 1 no. 1 Commercial Code; see also Art. 290 Commercial Code); liability for the giving of a property interest in connection with the exercise of shareholders' rights (Art. 266 para. 1 no. 2 Commercial Code; see also Art. 295 Commercial Code);[67] liability for loans to directors (Art. 266 para. 1 no. 3 Commercial Code); and liability for transactions involving a conflict of interest approved by the board of directors (Art. 266 para. 1 no. 4 Commercial Code).[68] In cases where an act causing liability has been performed based on a resolution of the board of directors, those directors who voted in favor of the resolution are deemed actors and are jointly and severally liable for the company's damages (Art. 266 para. 2 Commercial Code; hereinafter: Constructive Actor Provision). Directors who have participated in the resolution and have failed to state their objections in the minutes are presumed to have voted in favor of the resolution (Art. 266 para. 1 no. 3 Commercial Code).[69] These rigid rules were laid down to secure the fairness of execution in the 1950 reform, in which the rights of shareholders and corporate auditors were reduced and the powers of the board of directors were enlarged.[70]

However, these rules have been criticized for the following reasons. First, they are too strict. The severe liability for transactions involving a conflict of interest is not practical because there are a number of interlocking directorships today and intra-group dealings have become ordinary transactions.[71]

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67 The purpose of this liability is to eliminate the giving of property interests to so-called "*Sôkaiya*" (extortionists who threaten to disrupt shareholders' meetings) in publicly-held companies. Comments on Tentative Draft Part 4 Chap. 4, 7(5) no. 2.

68 EGASHIRA, *supra* note 21, 399-401. Some district courts, such as the Himeji branch of the Kobe District Court, have also decided that a liability for illegal dividends is a strict liability: Kobe District Court, April 11 1966, in: Kakyû Saibansho Minshû 17-3-4, 122. The Supreme Court has held that a liability for a transaction involving a conflict of interest approved by the board of directors is a strict liability: Supreme Court, October 20 2000, in: Minshû 54-8, 2619. However, scholarly opinion is divided on these liabilities. For example, M. TATSUTA, *Kaisha-hô* [Business Corporation Law] (10th ed Tokyo 2005) 88-89 interprets liabilities other than a loan to directors as *kashitsu sekinin* (a liability where directors are liable only when they acted with fault). For details of these theories, see K. UEYANAGI ET AL., *Shimpan chûshaku kaisha-hô* (6) [Annotated Company Law (6)] (Tokyo 1987) 258 f. (M. Kondô).

69 In the company law of the United Kingdom, with respect to a director's liability for breach of fiduciary duty, all directors who participate in the breach are jointly and severally liable: Palmer's Company Law (25th ed.) para. 8.542. Directors are regarded as participating in the breach when they are either actively participating or subsequently acquiescence in it: *Re Lands Allotment Co.* [1984] 1 Ch 616; and merely protesting will not necessarily disprove acquiescence: *Joint Stock Discount Co. v Brown* (1869) LR 8 Eq 381; PAUL L. DAVIES, Gower and Davies' Principles of Modern Company Law (7th ed. London 2003) 425 (n 21).

70 T. SUZUKI / T. ISHII, *Kaisei kabushiki kaisha-hô* [Revised Stock Corporation Law] (Tokyo 1951) 171.

71 I. KAWAMOTO, *Gendai kaisha-hô* [Modern Company Law] (9th ed. Tokyo 2004) 495.
Viewed in the light of comparative law, the rule of conflict of interest which takes interlocking directorships into consideration seems to be a noticeable characteristic of the

Second, the traditional interpretation mentioned above should be reviewed because the function of a corporate auditor has been improved in subsequent reforms.[72]

With respect to the liability of directors and executive officers in Companies with Committees, the 2002 reform clarified that liability for illegal dividends and liability for conflict of interest are *kashitsu sekinin* (a liability where directors are liable only when they acted with fault; hereinafter: fault liability; Art. 21-18, Art. 21-21 Exceptional Provisions). However, the burden of proof that they acted without fault is placed on the directors or executive officers. Also, there is no special provision for liability for loans to directors and this is now included in the liability for conflict of interest. Moreover, no general Constructive Actor Provision is laid down but is instead included in individual liability provisions where necessary (Art. 21-20 para. 1, Art. 21-21 para. 1 no. 3, Art. 21-24 paras. 2-4 Exceptional Provisions). The reason for these modifications for Companies with Committees is that such companies are regarded as having a superior corporate governance system which aims for complete control of management.

However, setting up an excellent governance system cannot be a ground for modifying the liability of a person who has acted illegally in spite of such a system. In any case, the reason the Company with Committees system and the Company with a Cor-

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company law of the United States — the conflict of interest regulation of which, as with English law, derives from the principles of trust law. For example, the company law of California applies a laxer rule to transactions involving interlocking directorships than other self-dealings: Cal. Corp. Code §310(b). The American Law Institute (ALI) limits the range of transactions involving interlocking directorships regulated as conflicts of interest: AMERICAN LAW INSTITUTE, Principles of Corporate Governance: Analysis and Recommendations (1994) Vol. 1 Chap. 2 § 5.07.

Also, in Japan, a district court considered the case of an interlocking director who financially supported one company within a group companies and held that transactions which are practically intended to enlarge a company's profit are not to be included in transactions regulated by Art. 266 para.1 no. 4 Commercial Code (specifying a director's liability for conflict of interest transactions): Osaka District Court, January 30 2002, in: Hanrei Taimuzu 1108 (2003) 248. This case is introduced in English in: E. TAKAHASHI / T. SAKAMOTO, Japanese Corporate Law: Important Cases in 2002 and 2003, in: ZJapanR 9-17 (2004) 241. However, this judgment is often criticized for its unreasonable and complicated interpretation and it is argued that, in order to completely solve the problem of interlocking directorships, liability for conflict of interest must be made a fault liability (C. NUNOI, Case Commentary, in: Kinyû Shôji Hanrei 1151 (2002) 60, 67; S. EBINA, Case Commentary, in: Zeikei Tsûshin [Tax and Accounting Correspondence] 58-1 (2003) 235, 241; E. KURONUMA, Case Commentary, in: Shihô Hanrei Rimâkusu [Remarks on Civil Cases] 27 (2003) 84, 87) or a new provision on transactions between group companies must be established (KURONUMA, *supra* note 71, 87).

Although it is not necessarily related to interlocking directorships, the range of conflicts of interest regulated as self-dealings will also be reduced in the review of the company law in the United Kingdom: Modernising Company Law, Cm 5553 (2002) Companies Bill schedule 2 para. 5; DEPARTMENT OF TRADE AND INDUSTRY, Company Law Reform, Cm 6456 (2005) Chap. 7; Company Law Reform Bill Part B Chap. 1 B6, B8.

72 M. KITAMURA, *Torishimari-yaku no sekinin* [Directors' Liabilities], in: Shôji Hômu 1695 (2004) 9, 9-10.

porate Auditor system are alternatives under the Commercial Code and the Exceptional Provisions seems to be that the latter is considered to be as good as the former. Therefore, the regulation imbalance between the two types of company is unreasonable. The new law adjusts this imbalance (Final Draft Part 2 Chap. 3, 3(8) no. 1).

First, liability for illegal dividends and liability for conflict of interest transactions have become fault liabilities for which the director bears the burden of proof (Art. 423 para. 3 Company Code). With respect to the liability for conflict of interest, however, a director who has entered into a direct transaction with the company for the benefit of himself/herself owes a strict liability and cannot be exempted from this liability (Art. 428 Company Code). This seems to be based on the theory that distinguishes *chûjitsu gimu* (duty of loyalty; Art. 254-3 Commercial Code; Art. 355 Company Code) from *zenkan chûi gimu* (duty of care; Art. 254 para. 3 Commercial Code; Art. 330 Company Code; Art. 644 Civil Code[73])[74] and advocates that a director who has acted in breach of the former duty must account to the company for any profits arising out of the breach.[75] The reason the new law does not impose a strict liability on a director who has profited from a third party's transaction with the company, involving a conflict of interest between the company and the director (Art. 356 para. 1 no. 2 Company Code), is that such a transaction is sometimes entered into while the interested director is unaware of the transaction.[76] Incidentally, a director who has profited from competition with the company is not treated in the way stated above. It therefore seems necessary to balance the liability of a director in competition with the company with that of a director in a conflict of interest transaction.[77]

The existing law does not provide as strict requirements for exemption from liability for a conflict of interest transaction (Art. 266 para. 6 Commercial Code) as it does for exemption from other liabilities (Art. 266 para. 5 Commercial Code) because a director who has entered into a conflict of interest transaction is liable despite obtaining the approval of the board of directors. This provision is repealed because, under the new

73 *Minpô*, Law No. 89/1896, as amended by Law No. 147/2004.

74 KITAMURA, *supra* note 72, 13. In Japanese company law, opinion is divided as to whether the duty of loyalty (Art. 355 Company Code) should be distinguished from the duty of care (Art. 644 Civil Code). Those who distinguish them view the duty of loyalty in the Japanese law as similar to the one in the Common Law. Those who do not distinguish them view the duty of loyalty as a category within the duty of care. In the opinion that distinguishes them, the duty of loyalty in Japanese law will be similar to the one in the Common law. For details, see UEYANAGI ET AL, *supra* note 68, 28-31 (M. Hamada).

75 M. KITAZAWA, *Kaisha-hô* [Company Law] (6th ed Tokyo 2001) 412. This theory follows the Common Law, which requires a director to account to the company for profits from a transaction involving a conflict of interest: DAVIES, *supra* note 69, 427; PALMER, *supra* note 69, para. 8.542. Egashira argues that the existing law should be revised to impose a strict liability on directors and third parties who profit from transactions involving conflicts of interest: EGASHIRA, *supra* note 21, 401.

76 Minutes No. 25.

77 KITAMURA, *supra* note 72, 13.

law, the liability for a conflict of interest transaction is a fault liability (Final Draft Part 2 Chap.3, 3(8) no. 3). Liability for a conflict of interest is also a fault liability in the case of a Company with Committees, but the existing law already has such a provision (Art. 21-21 paras. 1-2 Exceptional Provisions). The liability for conflicts of interest in Companies with Committees is not a simple fault liability but a special fault liability which imposes the burden of proof upon the director. Without such a provision, the requirements for exempting a director's liability in a Company with Committees would be stricter than that of Companies with a Corporate Auditor.[78] The provision mentioned above was laid down to resolve this problem. Therefore, the new law repeals this provision so as to accompany the repeal of the provision for Companies with a Corporate Auditor, as mentioned above (Final Draft Part 2 Chap. 3, 3(8) no. 3).

Second, the new law also treats the liability for loans to directors, in the case of Companies with a Corporate Auditor, as one kind of liability for conflict of interest. However, a loan to directors is dangerous and does not bring any profit to the company. The company law in a number of countries around the world therefore distinguishes loans to directors from conflict of interest transactions and prohibits the former. For example, the company law of the United Kingdom, in principle, prohibits loans to directors (Companies Act 1985 §330), but it permits conflict of interest transactions if the director discloses his/her interests in the transaction to the other directors (Companies Act 1985 §317, Table A Art. 85). Delaware corporations law used to prohibit loans to officers. This provision was repealed in 1963.[79] Although the existing law permits loans to directors when, in the judgment of the directors, the loan may reasonably be expected to benefit the corporation, it distinguishes loans from other conflict of interest transactions (Del. Code. Ann. tit. 8 §143). Also, §402 of the Sarbanes-Oxley Act, in principle, prohibits loans to directors. Under the Japanese law, loans to directors are not prohibited but this is dependent upon the precondition that the other directors of the company secure the loan jointly and severally. Therefore, as far as the law permits loans, the special provision on liability for loans to directors should have been maintained both for Companies with a Corporate Auditor and for Companies with Committees.

In addition to the adjustment of regulations, the general Constructive Actor Provision for all liabilities is repealed because it is unnecessary where some liabilities to the company have become fault liabilities (Final Draft Part 2 Chap. 3, 3(8) no. 1). Furthermore, the liability for the giving of a property interest in connection with the exercise of shareholders' rights, which is also a strict liability in Companies with Com-

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78 M. SHISEKI, *Heisei 14-nen kaisei shôhô no kaisetsu* [VII] [An Explanation of the 2002 Reform of the Commercial Code [7]], in: Shôji Hômu 1643 (2002) 18, 24.

79 EDWARD P. WELCH, Folk on the Delaware General Corporation Law: Fundamentals (Aspen, 2003) 238.

mittees under the existing law,[80] under the new law becomes a fault liability for directors who have participated in the giving of the property interest in both Companies with a Corporate Auditor and for Companies with Committees (Art. 120 para. 4 Company Code). A director who has carried out the giving a property interest, however, bears a strict liability (Art. 120 para. 4 Company Code). Under the new law, in addition to the director who has carried out the giving of a property interest, those directors who have agreed to it appear to be liable to pay a sum of property interest to the company. This rule prevents a director from escaping liability by insisting that another director gave the property interest to the shareholders without his/her notice.[81] This seems appropriate because a director appears to owe a duty to positively prevent the giving of a property interest in connection with the exercise of shareholders' rights.[82]

2. *Distribution of Surplus by the Board of Directors*

In addition to director's liability, the new law adjusts the regulations of both types of companies relating to the appropriation of profits. Under the existing law, in Companies with a Corporate Auditor approval by both the board of directors and the shareholders' meeting is required for proposals relating to appropriation of profits and disposition of losses (Art. 281 para. 1; Art. 283 para. 1 Commercial Code). On the other hand, in Companies with Committees the board of directors can decide on proposals relating to appropriation of profits and disposition of losses without the approval of the shareholder's meeting if the accounting auditor and the audit committee judge that the proposals are lawful (Art. 21-31 Exceptional Provisions). However, as mentioned above, both types of company are considered equally excellent corporate governance structures. Therefore, under the new law, in a Company with a Corporate Auditor – which has a board of directors, a board of corporate auditors and an accounting auditor – proposals relating to distribution of surplus (*jôyo-kin no haitô*)[83] can be approved by resolution of the board of directors without the approval of the shareholders' meeting, provided that this is permitted by the articles of incorporation (Art. 459 Company Code).

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80 The reason for this is that the giving of a property interest in connection with the exercise of shareholders' rights is quite anti-social. SHISEKI, *supra* note 78, 18.

81 K. YOSHIHARA, *Torishimari-yaku no sekinin to daihyô soshô* [Directors' Liabilities and the Shareholders Representative Action], in: Jurisuto 1267 (2004) 62, 69.

82 T. INABA, *Torishimari-yaku no sekinin no atarashii katachi* [The New Style of Directors' Liabilities], in: Shôji Hômu 1690 (2004) 13, 16.

83 The new law replaces the terms *rieki no shobun* (appropriation of profits) and *sonshitsu no shori* (disposition of losses) with the new term *jôyokin no haitô* (distribution of surplus). This is the equivalent, under the existing law, of (i) *rieki no haitô* (distribution of interest); (ii) *chûkan haitô* (interim dividends); and (iii) *shihon oyobi hôtei-junbikin nogenshô ni tomonau harai-modoshi* (refund payments in connection with reduction of stated capital or the legal reserve).

VI. SHAREHOLDERS' REPRESENTATIVE ACTION

1. Preventive Conditions on the Shareholders' Representative Action

The economic world has needed a system which enables a company to prevent so-called "strike suits" or suits bringing no merit to the company and to exempt the company from the procedural costs of such suits.[84] In order to answer this need, the establishment of the "litigation committee" was proposed at first (according to the Tentative Draft by the Working Group on the Modernization of the Company Law,[85] the litigation committee is a system whereby, if the litigation committee set up within a company decides not to sue a director, courts can, to a certain extent, defer to the committee's judgment). The proposal was, however, abandoned because there were problems with the organization of the litigation committee (number of members, capacity and independence of members, etc); the scope of the courts' ability to make judgment (whether the court can judge only the independence of the committee and procedural fairness or whether it can also judge the appropriateness of the committee's decision); and the relationship with the exemption from liability provided under the existing law (see Art. 266 para. 5 Commercial Code).[86]

Instead, the new law provides that shareholders are prevented from instituting a representative action where the shareholders intend to claim unfair interests for themselves or a third party, or to damage the company (proviso in Art. 847 para. 1 Company Code).

2. Notice of Reason for Refusal to File

When shareholders intend to pursue the liability of a director, they must first request that the company file against the director. Shareholders can only file a representative suit if the company refuses this request. Under the existing law, courts have no means to consider why the company has refused a shareholders' request for filing against a director. However, the reason for refusal sometimes can be the key to the settlement of controversy. It will be especially more important under the new law providing preventive conditions on the shareholders' representative action. The new law therefore requires the company to immediately give notice of the reason for refusal in writing ("document

84 M. NISHIKAWA, *Kabunushi daihyô soshô seido no saranaru minaoshi: tekisei na seido no kôchiku no tameni* [Further Review of the Shareholders' Representative Action], in: Shôji Hômu 1697 (2004) 32, 33, 35-36; NIHON KEIDANREN KEIZAIHÔKI IINKAI [The Business Law Committee of the Japanese Business Federation], '*Kaisha hôsei no gendai-ka ni kansuru yôkô shian' ni tsuite no iken* [An Opinion on 'The Tentative Draft on the Modernization of the Company Law'], available at *<http://www.keidanren.or.jp/japanese/policy/2003/127/>*.

85 *Kaisha hôsei no gendai-ka ni kansuru yôkô shian* [Tentative Draft on the Modernization of the Company Law; hereinafter: Tentative Draft], Part 4, 8 (note).

86 Minutes No. 25.

of the reason for refusal") to any shareholders who requested the filing, if they request such notice (Art. 847 para. 4 Company Code).

3. *Review of Standing to Sue*

The district courts are leaning toward the opinion that plaintiffs of representative actions for a prospective fully-owned subsidiary lose their standing to sue when they lose their status as a shareholder of the company through share exchange or stock transfer, and that in such circumstances the action should be dismissed by the court.[87] Such judgments have caused serious problems in the pursuit of directors' liability. As a typical example, we can consider the shareholders' representative action of Daiwa Bank in 2001. The District Court held that the directors were liable for a large amount of damages.[88] Despite this, on appeal the suit was settled with a significantly reduced sum of damages because Daiwa Bank had become, through stock transfer, a fully-owned subsidiary of Daiwa Bank Holding Corporation and the plaintiffs were to lose their standing.[89] Thus, there is some fear that the judgments of the lower courts recognizing the liability of directors are being spoiled by share exchanges or stock transfers executed before appeal to a higher court and, as a result, shareholders cannot enforce directors' liability. This situation is likely to harm people's reliance on the company law, which fails to address the problem; on the courts; and on the whole judicial system.[90]

Additionally, the judgments of the district courts, as mentioned above, can be criticized from a theoretical viewpoint. First, the complainant shareholders have not voluntarily lost their status as shareholders. Second, where they receive shares of the parent company through share exchange or stock transfer, they continue to have an interest in the subsidiary even after the share exchange or stock transfer.[91] For these reasons, there are a number of opinions opposed to the interpretation of the District Court.

87 Tokyo District Court, March 29 2001, in: Hanrei Jihô 1748 (2001) 171; Nagoya District Court, August 8 2002, in: Hanrei Jihô 1800 (2003) 150; Tokyo District Court, February 6 2003, in: Hanrei Jihô 1812 (2003) 143. The requirement for standing to sue — "shareholders having a share continuously for at least the preceding six months" — in Art. 267 para. 1 Commercial Code, is the main reason for such judgment.

88 Osaka District Court, September 20 2000, in: Hanrei Jihô 1721 (2000) 3.

89 This case has been criticized by the media as a share transfer with the object of escaping a representative action. See *e.g. Daiwa Ginkô tôdori no warudakumi: daihyô soshô nogare ni 'Asahi-gin' tôgô*", in: Sentaku 320 (2001) 76; *Daiwa Ginkô soshô 'itten wakai' daihyô soshô ga abunai*, in: Asahi Shimbun Weekly AERA 14-6 (2002) 20.

90 It is supposed that the settlement on appeal in the Daiwa Bank case was also aimed at preventing a judgment contrary to that of the District Court from harming the people's reliance on the whole judicial system: KABUNUSHI DAIHYÔ SOSHÔ SEIDO KENKYÛKAI, *Kabushiki kôkan, kabushiki iten to kabunushi daihyô soshô* [Share Exchanges, Stock Transfers and Shareholders' Representative Actions], in: Shôji Hômu 1680 (2003) 4, 5.

91 Ibid, 7.

In consideration of these discussions, the new law provides that shareholders of a prospective subsidiary do not, through share exchange or stock transfer, lose their standing to sue in representative actions of that company where they are given shares of the new parent company (Art. 851 para. 1 no. 1 Company Code). The reason the new law protects only shareholders who become shareholders of the parent company is related to the second theoretical problem mentioned above.

The same problems apply to shareholders who lose their status as a shareholder of the company through merger. Thus, the new law offers to such shareholders the same measures as those stated above. The new law provides that shareholders of a company extinguished through merger or other measures do not lose their standing to sue in representative actions where they become shareholders of the company surviving the merger (including cases where the shareholders of a company extinguished in a triangular merger receive shares of the surviving company's parent company, which the surviving company holds) (Art. 851 para. 1 no. 2 Company Code).

VII. ACCOUNTING AUDITOR

1. *Companies Permitted to Have an Optional Accounting Auditor*

As we mentioned above, the existing law requires Large Companies to have an accounting auditor. Although the law also permits other types of companies to have an accounting auditor via the Constructive Large Company system, Small Companies are excluded (Art. 2 para. 2 Exceptional Provisions). Venture businesses, however, need an accounting auditor to secure the objective fairness of the company's financial statements and to raise funds smoothly.[92] The new law therefore permits Small Companies to optionally have an accounting auditor, as long as this is permitted by a provision in the articles of incorporation (Art. 326 para. 2 Company Code; see also Final Draft Part 2 Chap. 3, 6(1)). Although the existing law requires a Constructive Large Company to adopt either the Company with Committees or the Company with a Corporate Auditor structure, the new law abolishes this rule because it is not reasonable for a Small Company to be required to adopt either structure.

Under the new law, companies are relatively free to design their own structure (see II.2. above). In relation to this, a problem arises when determining how freely a company with an accounting auditor is allowed to design its own structure. Under the existing law, the audit by an accounting auditor is combined with the audit by a corporate auditor,[93] and, under the new law, an accounting auditor's remuneration package

92 Comments on Tentative Draft Part 4 Chap. 4, 11 (2).

93 For example, the participation of the board of corporate auditors in the appointment and dismissal of an accounting auditor (Art. 3 para. 2; Art. 5-2 para. 3 Exceptional Provisions), the duty of an accounting auditor to report directors' malfeasance to the board of corporate

requires the approval of a corporate auditor (Art. 399 Company Code; see VII.2. below). Therefore, the new law requires a company with an accounting auditor to appoint either a corporate auditor (or a board of corporate auditors) or have the three committees (a Large Company which is not a Restricted Share-Transfer Company is required to appoint eit her a board of corporate auditors or the three committees; Art. 327 para. 3 Company Code).

2. Compensation of an Accounting Auditor

Under the existing law, the approval of the board of corporate auditors is required to appoint or dismiss an accounting auditor (Art. 3 paras. 2-3; Art. 5-2 para. 3; Art. 6 para. 3 Exceptional Provisions). On the other hand, there is no provision requiring the participation of the board of corporate auditors or the audit committee in a decision on an accounting auditor's compensation, and a representative director or a representative officer can negotiate with the accounting auditor and arbitrarily decide a compensation sum. Such a scheme is problematic from the viewpoint of the independence of an accounting auditor from the management. Among foreign laws, Art. 301 para. 2 of the Sarbanes-Oxley Act provides that the audit committee must bear direct liability for the appointment of an incorporated accounting firm, the decision as to that firm's compensation, and supervision over the firm. Also, according to Art. 111 para. 2 no. 3 of the Aktiengesetz of Germany, it is the role of the board of corporate auditors to appoint an accounting auditor.[94] Considering these circumstances in foreign countries, the new law gives the power to approve a decision on an accounting auditor's compensation to a board of corporate auditors (in cases where the company does not have a board of corporate auditors, the majority of corporate auditors) and to the audit committee (Art. 399 Company Code).

3. Accounting Auditors' Liability to the Company

Recently, it seems that there is a growing discussion throughout the world on the importance of external audit. Considering this, the new law permits shareholders to pursue an accounting auditor's liability to the company through a shareholders' representative action (Art. 847 para. 1 Company Code). Some have expressed the opinion that this is not appropriate because an accounting auditor is not an officer of the company.[95]

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auditors (Art. 8 para. 2 Exceptional Provisions) and so on.

94 M. YANAGA, *Kansanin no gaikanteki dokuritsu-sei* [The Apparent Independence of Auditors] (Tokyo 2002) 302.

95 See S. MORIMOTO, *Dai-kaisha no kanri unei to kaisha hôsei no gendai-ka ni kansuru yôkô shian* [*Chû*] [Management of Large Companies and the Tentative Draft on the Modernization of the Company Law [2]], in: Shôji Hômu 1700 (2004) 26, 32.

However, there is the same fear as with a director that the company may neglect to pursue an accounting auditor's liability because of their close connection with the management. Besides, accounting auditors fulfill an important function in the accounting of the company. It is therefore necessary to introduce a shareholders' representative action for an accounting auditor's liability to ensure the fairness of his/her audit activity. The new law also provides exemption or a contract for limitation of the accounting auditor's liability in the same way as for external directors (Arts. 424-427 Company Code).

The criterion for calculating the maximum amount of exemption is also the same as for that of external directors (Art. 425 para. 1 no. 1 Company Code).[96] As there was originally no provision about exemption of an accounting auditor's liability, a company seems to be freely able to conclude a contract of exemption of liability with its accounting auditor.[97] There is therefore some fear that companies may take advantage of the exemption of liability as a means to negotiate for a reduction of an accounting auditor's remuneration and consequently the quality of audit by the accounting auditor may deteriorate.[98] The new law sets the maximum amount of exemption on the basis of an

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96 Namely, the maximum amount of exemption is the balance of the amount of damages for which an accounting auditor would be liable, after subtraction of the amount equal to double the highest total amount of property interests the accounting auditor received, or is entitled to receive, as remuneration or other compensation for the performance of his/her duties during the business year in which falls the date on which the shareholders' meeting adopting such resolution was concluded, or any of the preceding business years: Art. 425 para. 1 no. 1 Company Code; Art. 266 para. 7 no. 1; Art. 266 para. 18 Commercial Code).
During the preparation of the reform proposal, the issue of which limit of exemption should be adopted for an accounting auditor's liability was discussed. The three options were:
(i) that of an outside director's liability (the balance of the amount of damages after subtraction of double the amount of property interests he/she received from the company; Art. 266 para. 7 no. 1, Art. 266 para. 18 Commercial Code); (ii) that of a director's liability (the balance of the amount of damages after subtraction of quadruple the amount of property interests he/she received from the company; Art. 266 para. 7 no. 1 Commercial Code); or (iii) that of a representative director's liability (the balance of the amount of damages after subtraction of six times the amount of the property interests he/she received from the company; Art. 266 para. 7 no. 1, Art. 266 para. 17 Commercial Code). However, the issue is not which amount an accounting auditor's liability should be balanced with, but which limit is more effective as a sanction (see Minutes No. 11).
There is an opinion that the limit of exemption of an accounting auditor's liability should be lower than that of a representative director's liability because it should be a director (and an accounting consultant) who prepares the financial statements and an accounting auditor only audits it. Similarly, it should be higher than that of an outside director's liability because he/she is a specialist in accounting: MORIMOTO, *supra* note 95, 33; Minutes No. 24. For a similar opinion, see N. KOGAKI, *Kabushiki kaisha to yûgen kaisha no kiritsu no ittaika, kaikei kansa-nin* [The Harmonization of Stock Company Rules, Limited Liability Company Rules, and Accounting Auditors], in: Shôji Hômu 1695 (2004) 17, 20.

97 E. KURONUMA, *Kikan: kaikei kansa-nin* [The Organ: An Accounting Auditor], in: Shôji Hômu 1688 (2004) 32, 36.

98 Minutes No. 23; Minutes No. 24.

accounting auditor's compensation, which the company cannot reduce even by contract. Since an accounting auditor has the function of protecting creditors, it may be thought that the law should provide a concrete sum limit on exemption.[99] However, we think that the limit on exemption of an accounting auditor's liability should be based on their compensation,[100] as under the new law, or the law should provide concrete sum limits in addition to the compensation-based limit because compensation-based limits can more effectively reflect what is appropriate in relation to the size of each company. Incidentally, German law provides a concrete maximum sum for which an accounting auditor must bear liability (Art. 323 para. 2 HGB).[101]

4. *Where an Accounting Auditor is of the Opinion that Financial Statements are Illegal*

Under the existing law, the balance sheet and profit/loss statement can be approved by the shareholders' meeting (Art. 16, Art. 21-31 Exceptional Provisions) and appropriation can be carried out even if an accounting auditor is of the opinion that the balance sheet and profit/loss statement are illegal (Art. 283 para. 1 Commercial Code).[102] In contrast, the new law requires a company to show clearly in the public notice of accounts where an accounting auditor is of the opinion that the financial statements are illegal or he/she states that he/she could not make the necessary investigation for an audit (Art. 440 Company Code). This is because the approval of the shareholders' meeting cannot make illegal financial statements legal, and once an accounting auditor – a specialist in accounting – is of the opinion that the statements are illegal, the company should disclose this to its creditors and other stakeholders.[103]

5. *Registration of an Accounting Auditor*

The new law requires a company to register the fact that it has an accounting auditor and the accounting auditor's name (Art. 911 para. 3 no. 19 Company Code). This is due to the fact that whether or not the company has an accounting auditor is important to the

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99 Minutes No. 24; MORIMOTO, *supra* note 95, 33.

100 KOGAKI, *supra* note 96, 20.

101 However, the reason for providing a concrete maximum sum of liability is to enable an accounting auditor to be protected by legal audit insurance and to enable a company required to be audited by an accounting auditor to engage one easily. M. YANAGA, *Kaikei kansa-nin no sekinin no gentei* [Limitations on Accounting Auditors' Liability] (Tokyo 2000) 164.

102 However, such situation is scarcely seen in the case of listed companies because such an opinion on the part of an accounting auditor may lead to them being delisted: E. KURONUMA, *Kansa-yaku□kaikei kansa-nin* [Corporate Auditors and Accounting Auditors], in: Jurisuto 1267 (2004) 73, 79.

103 See Comments on Tentative Draft Part 4 Chap. 4, 11 (4).

company's creditors and other stakeholders, and the new law expands the range of companies which optionally can have an accounting auditor (see VII.1. above).[104] Especially for small companies, this will help to ensure smooth fundraising.[105]

6. *Other*

In addition to the items mentioned above, at the beginning of work on the reform, it was proposed that the existing criteria for determining which companies must have an accounting auditor should be revised and new criteria based on information such as total assets, sales and the number of employees of the company, as with the EU law, should be introduced (Tentative Draft Part 4 Chap. 4, 11(1) no. 1). However, this proposal was abandoned because a number of Large Companies, which are obliged to have an accounting auditor even under the existing law, do not have an accounting auditor at present. The effectiveness of this regulation was questioned,[106] and it would therefore be difficult to introduce the new criteria now.[107]

Moreover, it is also argued that a fully-owned subsidiary preparing consolidated financial statements should not be required to have an accounting auditor because it is actually audited by an accounting auditor of its parent company (Tentative Draft Part 4 Chap. 4, 11(1) no. 3). However, this proposition has, on occasions, been strongly opposed,[108] and it will be addressed again in discussions to establish a combined corporate law in the near future.[109] Thus, this proposal was also abandoned in the 2005 reform.

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104 KURONUMA, *supra* note 97, 36.

105 Comments on Tentative Draft Part 4 Chap. 4, 11 (8).

106 S. IWAHARA, *Kaisha kubun*・*Kaisha kikan kankei* [Separation of Companies - Corporate Structure], in: Shôji Hômu 1686 (2004) 12, 15.

107 Minutes No. 23.

108 There exist the following reasons for opposition. First, an audit by an independent specialist is necessary for fully-owned subsidiaries because even fully-owned subsidiaries often have a lot of creditors and other stakeholders. Second, without an audit by an accounting auditor, stakeholders of the subsidiary will not be sufficiently protected because the existing law does not require the parent company to guarantee its subsidiaries' debts. Third, there are many fully-owned subsidiaries which independently run their own business and are not subject to the regular control of their parent company. Fourth, an accounting auditor should audit the subsidiary directly in order to clarify its liability (T. AIZAWA ET AL., *Kaisha hôsei no gendai-ka ni kansuru yôkô shian ni taisuru kakukai iken bunseki* [An Analysis of the Opinions of Various Fields on the Tentative Draft on the Modernization of the Company Law], in: Bessatsu Shôji Hômu 273 (2004) 1, 43-44. Finally, where the parent company is purely a holding company, the subsidiaries should be required to have an accounting auditor because the business of the group is actually executed by the subsidiaries and the group's majority stakeholders are affected by them: MATSUI, *supra* note 62, 48.

109 Minutes No. 23; Minutes No. 24.

VIII. REFORMS TO RELAX REGULATIONS AND ANSWER BUSINESS NEEDS

The following are examples of reforms to relax regulations and to answer business needs, other than the relaxation of directors' liability (see V.1. above). First, the new law permits a company to extend the term during which shareholders may exercise their right to make proposals (Art. 303 para. 2 Company Code), provided it is permitted by the articles of incorporation, in order to increase the number of occasions at which shareholders may exercise their rights. Second, the provision limiting the location of convocation to the location of the head office or a location adjacent thereto (Art. 233 Commercial Code) is to be repealed. Third, a company is permitted to appoint an inspector of the shareholders' meeting to answer the need to secure the objective fairness of the meeting procedure (Art. 306 para. 1 Company Code). Fourth, the system of exercising voting rights in writing or via electromagnetic devices in a shareholders' meeting has been reviewed (Arts. 239-2, 239-3 Commercial Code; Art. 298 para. 1 no. 3, Art. 298 para. 2, Art. 311, Art. 312 Company Code). Fifth, a company is permitted to have a provision in its articles of incorporation allowing for a resolution of the board of directors in writing or via electromagnetic devices (Art. 370 Company Code). Sixth, the requirement of having an important assets committee, devised in the 2002 reform, is relaxed in order to eliminate the prevention of prompt decision-making in companies with a large board of directors (Art. 373; proviso in Art. 383 para. 1 Company Code). Finally, companies are permitted to elect a substitute officer in advance (Art. 329 para. 2 Company Code).

Below we explain those matters which seem to be especially important.

1. Reasons for Disqualification of Directors

The new law excludes "a person adjudicated bankrupt who has not been rehabilitated" (Art. 254-2 para. 2 Commercial Code) from reasons for disqualification of directors (see Art. 331 para. 1 no. 3 Company Code). In a medium or small-sized company, the management often individually guarantees the company's debt. Where the company is adjudicated bankrupt, members of management are often pursued for guarantor's liability and are declared bankrupt. As a result, the members of management are disqualified as directors by Art. 254-2 para. 2 of the Commercial Code. However, recently, bankruptcy proceedings such as the Civil Reconstruction Law,[110] enacted in 2000, in which the management works on re-establishing the company while retaining their status as directors, are being watched with interest in the economic depression. This is because giving a bankrupt management the opportunity to conduct business is thought to help stimulate economic activity.[111] If a bankrupt were not permitted to be a director, then

110 *Minji saisei-hô*. Law No.225/1999, as amended by Law No. 124/2004.
111 Comments on Tentative Draft Part 4 Chap. 4, 2 (2).

companies would not be able to use such a proceeding. The new law intends to prevent such a situation and to facilitate bankruptcy proceedings.

A person who has been sentenced to a criminal penalty for a crime and has not completed the requirements of such penalty cannot be a director (Art. 254-2 nos. 3-4 Commercial Code; Art. 331 para. 1 nos. 3-4 Company Code). Under the existing law, a crime under the company law is distinguished from a crime under other laws and the former is treated more strictly than the latter. This is because a person who has been sentenced to a criminal penalty for a crime under the company law, which regulates directly the order of companies, is considered more unqualified to be a director. The new law includes a crime under the Securities and Exchange Law[112] and crimes under all kinds of bankruptcy law in the category of crimes treated more strictly (Art. 331 para. 1 no. 3 Company Code). The reason for such amendments is that the Securities and Exchange Law is the basic law regulating stock exchange and is closely connected with the order of publicly-held companies, and bankruptcy law is also closely connected with the order of companies.[113]

2. Dismissal of a Director

To ensure the position of a director,[114] under the existing law a special resolution of the shareholders' meeting (Art. 343 Commercial Code)[115] is required to dismiss a director (Art. 257 para. 2, Art. 257-3 para. 2 Commercial Code). Under the new law, however, the shareholders' meeting can dismiss a director by ordinary resolution (Art. 341 Company Code).[116] This is because, under the new law, a company with a board of directors, a board of corporate auditors and an accounting auditor is permitted to decide the distribution of surplus by resolution of the board of directors, without approval of the shareholders' meeting (Art. 459 Company Code; see V.2. above) and so it is necessary to facilitate the shareholders' control over directors through the appointment and dismissal of a director.

The English law (Companies Act 1985 §303 para. 1) and the French law (Code de Commerce §L225-75, §L225-18) require an ordinary resolution of the shareholders'

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112 *Shôken torihiki-hô*. Law No. 25/1948, as amended by Law No. 124/2004.

113 Ibid.

114 EGASHIRA, *supra* note 21, 345.

115 The resolution must be adopted by a vote of two-thirds or more of the voting rights of all shareholders present at the shareholders' meeting. The quorum for a special resolution at a shareholders' meeting is a majority of the total voting rights of all shareholders or the number of voting rights specified in the articles of incorporation (Art. 343 para. 1 Commercial Code).

116 The resolution must be adopted by a majority of the voting rights of the shareholders present, who must represent a majority of the voting rights of all shareholders who can exercise voting rights, unless the company's articles of incorporation provide otherwise (Art. 341 Company Code).

meeting to dismiss a director. In the United States, an ordinary resolution is required for dismissal of a director under the Model Business Corporation Act (MBCA §7.25). Although the company law of California requires a special resolution, which is the same as the resolution for modification of the articles of incorporation, the requirement for a special resolution is a majority of the voting rights of outstanding stock and this requirement is a somewhat relaxed one (Cal. Corp. Code §303 para. (a); §152). Therefore, it seems appropriate from the viewpoint of comparative law that the new law permits dismissal of a director by ordinary resolution.

A director appointed by means of cumulative voting (Art. 342 para. 1 Company Code) cannot be dismissed by ordinary resolution (Art. 342 para. 6, Art. 309 para. 2 no. 7 Company Code) due to the purpose of the cumulative voting system.[117]

A special resolution is required to dismiss a corporate auditor under the new law as well as under the existing law because of the need to ensure the position of a corporate auditor (Art. 309 para. 2 no. 7 Company Code).[118]

IX. CONCLUSION

The ideal corporate governance structure seems different from company to company. The new law, which permits companies to more freely design their corporate governance structure, could realize a more suitable governance structure for each company.

We agree with the efforts to provide more suitable regulations for small closely-held companies because it will help the development of venture business and the encouragement of enterprise, which are needed under a deflationary depression. However, considering only small-sized companies does not entirely cover the matters of closely-held companies. There are now many large fully-owned subsidiaries. In this respect, it is noteworthy that the new law provides various options for corporate governance structure, with the combination of two different bases to separate regulations – namely, the basis of shareholder fluidity and the basis of company size.

Although the state of the Japanese economy is still uncertain, it is said that the most difficult part is over and that companies will recover their strength. In these circumstances, the management of companies will be expected to manage their business much

117 Cumulative voting is a technique introduced to give minority shareholders sufficient voting power to elect their representative to the board of directors. In cases where cumulative voting is demanded in a resolution for the appointment of directors, the number of voting rights attaching to each share shall be equal to the number of directors to be appointed. In such cases, each shareholder may exercise his/her voting rights by voting for only one candidate or by voting for two or more candidates (Art. 342 para. 3 Company Code). Candidates shall be deemed to have been appointed as directors in the order of votes received (Art. 342 para. 4 Company Code).

118 Minutes No. 20.

more positively and boldly. Viewed in this light, we approve of the relaxation of regulations on director's liability and the amendments relating to shareholders' representative actions in the new law. However, this relaxation of the regulations must lead to the realization of liability of the management.[119]

With respect to the introduction of an accounting consultant and the expansion of the range of companies permitted to have an accounting auditor, the business world expects them to be able to secure the objective fairness of financial statements and to ensure smooth fundraising. However, the substantial purpose of these rules is to secure actual fairness in financial statements. If an accounting consultant or an accounting auditor is used to give the impression of fair financial statements, it would be contrary to this purpose. In the interests of preventing such a situation, we agree that shareholders should, under the new law, be able to pursue the liability of an accounting consultant or an accounting auditor through shareholders' representative actions.

The purpose of the recent reform of company law is to improve the efficiency of management and bolster an international competitive edge. The realization of this purpose will also depend on whether the new law improves the soundness of management. This is because good corporate governance is an important factor in foreign investment, which is now a key to the success of the Japanese economy. We believe the new law still has some problems in this area. We will need to examine the implementation of the new law to see whether the 2005 reform guarantees the soundness of management in Japan and improves the international competitiveness of Japanese companies in a real sense.

ZUSAMMENFASSUNG

Mit der grundlegenden Reform des japanischen Gesellschaftsrechts im Jahre 2005 ist die Vielzahl von Reformen der jüngsten Vergangenheit auf diesem Rechtsgebiet zu einem vorläufigen Abschluß gekommen. Der nunmehr vorliegende endgültige Gesetzesentwurf vom Juni diesen Jahres nennt die Schaffung eines allgemein verständlichen Gesellschaftsrechts als eines der wesentlichen Ziele der Reform. Insbesondere galt es, die altmodische Sprache zu modernisieren, die seit der Inkraftsetzung des Handelsgesetztes in der Meiji-Ära nicht mehr geändert worden war. Auch sollten Fachbegriffe neu geordnet und Auslegungsfragen geklärt werden. Zudem wurden die auf Gesellschaften bezogenen Gesetzesvorschriften (Teil II des Handelsgesetzes, das GmbH-Gesetz und das Gesetz über Ausnahmen vom HG) in einem neuem Kaisha-hô *(Gesell-*

119 KITAMURA, *supra* note 72, 15. Inaba considers that the director's liability (of a Company with a Corporate Auditor) under the existing law is too strict and actually makes a director's liability merely nominal: INABA, *supra* note 82, 13.

schaftsgesetz) zusammengefaßt. Ein weiteres grundlegendes Reformziel war die Überprüfung und Anpassung des häufig reformierten Gesellschaftsrechts in einer kohärenten Kodifikation, die mit der aktuellen gesellschaftspolitischen und wirtschaftlichen Situation in Japan in Einklang steht. Der Beitrag analysiert die wichtigsten Aspekte der Reform, die sich auf die corporate governance *beziehen.*

Erstens hat die Reform eine neue Option für die Strukturierung der corporate governance *in kleinen Aktiengesellschaften eingeführt: den* accounting consultant (kaikei san'yo). *Bei diesem Modell hat ein Rechnungsprüfer an der Vorbereitung des Finanzberichts der Gesellschaft mitzuwirken. Diese neue Position soll die Richtigkeit des Berichtes sicherstellen.*

Zweitens wurden die Verantwortungsbereiche von Mitgliedern des Verwaltungsrats geändert. Dadurch sollten bestehende Unterschiede in den Regelungen über die Verantwortlichkeit der Verwaltung bei Gesellschaften mit einem corporate auditor *und bei Gesellschaften beseitigen werden, die das Ausschuß-Modell gewählt haben. Bei der Neugestaltung wurde auch die Kritik berücksichtigt, daß die bestehenden gesetzlichen Regelungen zur Organverantwortlichkeit insgesamt überholt und zu starr seien.*

Drittens sieht das neue Gesetz Einschränkungen bei der Erhebung von Aktionärsklagen vor. Die japanische Wirtschaft benötigte eine Regelung, die Gesellschaften in die Lage versetzt, räuberische Klagen oder allgemein Klagen, die der Gesellschaft als solcher keinerlei Vorteil bringen, zu verhindern und sie von den Kosten derartiger Verfahren zu entlasten. Das Gesetz verhindert nunmehr die Erhebung von Aktionärsklagen, die lediglich dem Zeck dienen, den klagenden Aktionären oder Dritten ungerechtfertigte Vorteile zu verschaffen, oder die Gesellschaft gezielt schädigen sollen.

Schließlich besteht künftig die Möglichkeit, eine Aktionärsklage zu erheben, wenn Schadensersatzansprüche der Gesellschaft gegen einen Bilanzprüfer durchgesetzt werden sollen. Diese Regelung wurde geschaffen, weil die Befürchtung bestand, daß eine Gesellschaft es wegen ihrer engen Verbindung zu den Prüfern unterlassen könnte, gegen diese vorzugehen. Die Neuregelung entspricht der bisher schon bestehenden Klagemöglichkeit zur Geltendmachung von Ersatzansprüchen gegen Verwaltungsratsmitglieder. Wie bei externen Verwaltungsratsmitgliedern sieht das neue Gesetz auch für die Prüfer einen Ausschluß oder eine vertragliche Begrenzung ihrer Haftung vor.

Obwohl die künftige Entwicklung der japanischen Wirtschaft noch immer ungewiß ist, nimmt man allgemein an, daß die schwierigste Phase der Krise inzwischen überwunden ist und die japanischen Unternehmen bald wieder ihre frühere Stärke erreichen werden. Um beurteilen zu können, ob die Reform des Jahres 2005 tatsächlich zur Solidität der Unternehmensführung beiträgt und die internationale Wettbewerbsfähigkeit japanischer Unternehmen verbessern kann, wird man aber erst noch die Umsetzung der neuen Regelungen in der Praxis untersuchen müssen.

(Deutsche Übersetzung durch die Redaktion)