



Simmons & Simmons

# Recent amendments to the Japanese Commercial Code

Amendments of November  
and December 2001

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# Executive summary

## 1. Deregulation of the share system

The "Partial Amendment of the Commercial Code" (the "November Amendment"), enacted in November 2001, comprises a wide-ranging review of matters relating to shares. It includes a review of the regulations governing new issues of shares, the flexibility of share classes and the creation of share options. The November Amendment is intended to facilitate flexible financing and efficient corporate management.

## 2. Corporate document digitisation

Reflecting the increasing IT-orientation of society, the November Amendment allows companies to use electronic means to produce corporate documents. In addition, both companies and shareholders are permitted to send requests or notices in electronic form. However, since not all intended recipients will have access to electronic facilities, the consent of the recipient must be obtained when producing in electronic form documents which were required to be sent or submitted in writing under the pre-amendment Commercial Code.

## 3. Corporate governance

The "Amendments to the Law for Special Exceptions to the Commercial Code Concerning Audit, Etc." (the "December Amendment"), enacted in December 2001, has strengthened the role of statutory auditor while relaxing requirements in connection with the indemnification of directors.

## 4. Schedule for further Commercial Code reform

The November Amendment and the December Amendment were enacted in 2001 (the Commercial Code in its revised state pursuant to the November Amendment and the December Amendment is referred to herein as the "Revised Code"). As of April 2002, further reform proposals are under discussion at the 154th regular Diet session. The schedule for further Commercial Code reform is as follows:

As at 23 April 2002

Legislation	Date of enactment	Date of promulgation	Date of entry into force
June Amendment	22 June 2001	29 June 2001	1 October 2001
November Amendment	21 November 2001	28 November 2001	1 April 2002
December Amendment	5 December 2001	12 December 2001	1 May 2002
Bill (2002)	Under discussion	Undecided	Undecided

# Part A: Deregulation of the share system

## 1. Issues of new shares

### 1.1 Issued and authorised share capital

Under the provisions of the Commercial Code which applied before the amendments detailed in this paper (the "Previous Code"), companies were required upon incorporation to issue at least one quarter of their total authorised share capital as set out in their Articles of Incorporation. Companies were also required on an ongoing basis to ensure that their authorised share capital did not exceed four times their issued share capital.

These restrictions have long been criticised as representing an obstacle to convenient, flexible financing. As a result of the November Amendment, they have now been abolished in the revised Commercial Code (the "Revised Code") in respect of companies whose Articles of Incorporation restrict the transfer of shares without board approval ("Restricted Transfer Companies").

### 1.2 Revisions in relation to new share issues

#### (A) **Validity of resolutions approving issues of shares at a discount**

In order to issue shares at a discount to a person who is not currently a shareholder of the company, the board of directors must resolve to issue the shares and in addition a special resolution approving the share issue must be passed in a shareholders' meeting.

Under the Previous Code, the requisite special resolution covered only new shares which:

- (1) were issued in a single issue following the passing of the resolution; and
- (2) were fully paid up within six months of the date of the resolution.

Once a particular class of shares, the number of shares to be issued and the minimum issue price have been authorised by special resolution in shareholders' meeting, companies should, however, be able to issue new shares from time to time according to their needs in order to be able to take advantage of corporate financing opportunities in a timely fashion. In addition, it is more helpful for the company if the resolution can be valid for at least one year from the date on which it is passed.

In pursuance of these benefits, the Revised Code has abolished the first requirement set out above and extended the six-month period featured in the second requirement to twelve months.

**(B) Share issues by Restricted Transfer Companies – special resolution**

Under the Previous Code, issues of shares by Restricted Transfer Companies to persons who were not already existing shareholders required a special resolution in shareholders' meeting. This resolution had the same application as the special resolution required in respect of issues of shares at a discount, as discussed in the preceding subsection.

The Revised Code acts to remove the single-issue restriction (the same as that set out in 1.2(A)(1) above) in respect of issues of shares by Restricted Transfer Companies. In addition, it extends the period for paying up shares (the same as that set out in 1.2(A)(2) above) from six months to twelve months.

**(C) Shares issues by Restricted Transfer Companies – board resolution**

Other than where shares were being issued at a discount to a third party who was not an existing shareholder in the company, the board of directors was not generally required under the Previous Code to pass any resolution regarding the party to whom new shares were proposed to be issued. However, transfers of shares in Restricted Transfer Companies required board approval of matters such as the identity of the transferee and the number and class of shares being transferred.

In order to extend the coverage of the regulation governing share transfers so that it applies also to share issues, the Revised Code provides that the board of directors must now approve the allottee as well as the number and class of shares to be allotted to him.

## 2. Classes of share

### 2.1 Shares with limited voting rights

Under the Previous Code, companies were able to create preferred shares carrying no voting rights. However, the Previous Code did not permit companies to allocate special voting rights to a particular class or series of shares in their Articles of Incorporation.

The Revised Code broadens the range of characteristics which may be assigned to different classes of shares. It also allows the issue of the following voting and non-voting classes of share:

- (A) non-voting shares carrying a right to participate in dividends (with the right to participate in dividends being either the same as or different from the dividend participation right attaching to ordinary shares); and
- (B) shares with limited voting rights (*giketsuken seigen kabushiki*), which are defined to include both (i) non-voting shares and (ii) shares carrying voting rights only in relation to certain specified matters.

Under the Revised Code, shares with limited voting rights form a particular class of shares. The Revised Code no longer provides for the resuscitation of voting rights where dividends remain unpaid (this was a feature of the Previous Code). Instead, companies are free to set out in their Articles of Incorporation the precise circumstances (if any at all) in which voting rights may be resuscitated.

This revision aims to respond to the need for companies to be able to create a class of ordinary share without voting rights. It also addresses the need when issuing tracking stock (where the shares' dividends are linked to the profits of a particular division or subsidiary of the issuing company) to be able to create shares which are not preferred shares but which have limited voting rights.

## **2.2 Limitation on the issue of shares with limited voting rights**

The Revised Code has increased the limit on the number of shares with limited voting rights which may be issued to one half of the total of shares in issue.

## **2.3 Matters to be provided in Articles of Incorporation**

The Previous Code required the maximum amount of dividends payable on preference shares to be set out in the issuing company's Articles of Incorporation. The maximum amount was also required to be provided as a set figure.

Companies, however, wanted the maximum amount to be able to be provided as a formula. It also became apparent that, where two or more different classes of preference shares were in issue, it might be unclear how the Articles of Incorporation were to apply.

As a result, the Revised Code now allows companies to provide in their Articles of Incorporation either a maximum amount or a formula for calculating the value of the dividend to be paid to preference shareholders.

## **2.4 Shareholders' meetings by particular class**

The Revised Code allows companies to provide in their Articles of Incorporation that certain matters may be subject to resolution by a particular class of shareholders in addition to resolution by ordinary shareholders and the board of directors.

This provision aims to protect the rights of class shareholders and to clarify the legal status of class shareholder rights which are set out in shareholder agreements but not in Articles of Incorporation. It is also intended to allow the grant of veto rights in relation to particular matters to class shareholders.

### 3. Convertible shares

The Previous Code provided in relation to convertible shares that certain shares of one class may be converted into another class of shares upon the request of the shareholder.

In addition to this type of convertible share, the Revised Code now allows companies to require the compulsory conversion of one class of share into a different class of share upon the occurrence of given events specified in the Articles of Incorporation.

Following this amendment in the Revised Code and in order to distinguish between the two types of convertible shares, the type of convertible shares provided for under the Previous Code has been renamed "shares with rights of conversion" (*tenkan yoyakuken tsuki kabushiki*) while the new type of convertible shares has been named "compulsory convertible shares" (*kyosei tenkan joukou tsuki kabushiki*).

### 4. Share options (*shinkabu yoyakuken*)

#### 4.1 Shares with limited voting rights

The Revised Code provides for the creation of options to acquire new shares with limited voting rights.

When this kind of option is exercised, the issuing company must either issue new shares or transfer treasury stock in the company to the person exercising the option.

#### 4.2 Procedure for issuing options

The Revised Code sets out a series of provisions in relation to the issue by a company of options over its shares. These are similar to those which apply in relation to the issue of new shares and the board of directors is therefore generally required to resolve relevant matters in connection with the issue of options.

In addition, the Revised Code sets out provisions regarding the public announcement and allotment of, and subscription and payment for, share options. Again, these are similar to those which apply in relation to new issues of shares.

### **4.3 Use of options**

The two methods used under the Previous Code to grant share options were the grant of warrants or the transfer of treasury shares. A company was able to grant share options only to its own directors and employees, while the period for exercising the options was limited to a maximum of 10 years. Companies were also prevented from issuing options over shares representing more than one tenth of their shares in issue at the time.

However, the Revised Code has removed these restrictions and, as a result, the use of share options is no longer limited to the issue of shares to incentivise directors and/or employees. Share options may now be issued not only to directors and/or employees but also to managers of subsidiaries or affiliated companies, as well as to outside consultants or customers.

### **4.4 Issue of options on favourable terms**

In order to issue share options on favourable terms to a person who is not an existing shareholder, a special resolution approving the issue must be passed at a shareholders' meeting and the board must also resolve to make the issue. This is the case even where the issuing company's Articles of Incorporation allow the issue of options on favourable terms.

Where a company is issuing new shares, the only "term" which can be "favourable" is the issue price. However, in the context of share options (as opposed to new shares), the definition of "favourable terms" is broad. The definition covers the issue price, the exercise price, the exercise period and the conditions attaching to the exercise of the option.

One example of what would therefore constitute an issue of share options on favourable terms is where the price to be paid for the new shares issued upon the exercise of the option is less than the reasonably forecasted market price for the shares over the option exercise period.

## **5. Bonds with share options** (shinkabu yoyakuken tsuki shasai)

### **5.1 Background**

The Previous Code permitted the issue of only two types of bond with an equity element: convertible bonds and bonds with warrants (both detachable and non-detachable).

Now, however, the Revised Code allows for the issue of share options (see the preceding section), while convertible bonds and bonds with warrants are each deemed to be a combination of bonds and share options. As a result, the provisions of the Previous Code regarding convertible bonds and bonds with warrants have been superseded.

### **5.2 Convertible bonds under the Previous Code and bonds with share options**

A convertible bond under the Previous Code is now to be seen as a bond with a share option attached. However, various limitations apply:

- (A) a bond with a share option attached may not be split and transferred in its separate "bond" and "attaching share option" elements;
- (B) the amount to be paid when exercising the option must be the same as the issue price of the bond; and
- (C) upon the exercise of the option, the bond must be redeemed and the redemption amount must be used in payment of the price required to exercise the option.

### **5.3 Bond with warrants (detachable type) under the Previous Code**

Bonds issued with detachable warrants under the Previous Code are now to be treated as the issue and allotment of, simultaneously, both a bond and a share option.

### **5.4 Bonds with warrants (non-detachable type) under the Previous Code and bonds with share options**

Bonds with non-detachable warrants under the Previous Code fall to be seen as bonds with share options attached. Separate transfer of the individual elements of the security is prohibited as set out in subsection 5.2 above.

## **6. Treatment of share options upon a share-for-share exchange (kabushiki kokan) or share switch (kabushiki iten)**

The Revised Code sets out how share options issued by a company (the "Grantor") should be treated in the event of a corporate reorganisation.

Under these, a company (the "Parent") which becomes the wholly-owning parent company of the Grantor as a result of a share-for-share exchange (kabushiki kokan) or share switch (kabushiki iten) is entitled upon the fulfilment of certain conditions to succeed to (and therefore exercise) share options issued by the Grantor.

There is also a process for the Grantor to cancel share options on a share-for-share exchange or share switch. This is available if the board of the Grantor passes a resolution at the time the share options are issued (together, if the issue is on favourable terms, with a special resolution passed in shareholders' meeting) that the share options will be cancelled upon the Grantor becoming a wholly-owned subsidiary of the Parent.

## Part B:

# Corporate document digitisation

### 1. General

In view of the increasing IT-orientation of society, the Revised Code provides for companies to produce corporate documents in electronic form and for companies and their shareholders to send requests and notices in electronic form. However, when producing in electronic form any documents which were required to be sent or submitted in writing under the Previous Code, the consent of the recipient of the document must be obtained.

### 2. The digitisation of corporate documents

- 2.1 Providing the recipient of the communication has given his consent, companies may send communications such as requests and notices to certain persons (including shareholders or bondholders) in electronic form, instead of sending the relevant communication or submitting the relevant document in writing. Acceptable means of electronic communication include e-mail, posting on internet sites and the delivery of diskettes.
- 2.2 Documents such as Articles of Incorporation and shareholder registers are required to be produced in writing but may not necessarily be communicated to anyone. The Revised Code stipulates that information which is to be recorded in these kinds of documents may be produced in electronic form and that the resulting electronic record may be deemed to be a written record.
- 2.3 Where a signature is required on a document, the author of the document in electronic form must take steps to replicate the signature digitally. It is anticipated that electronic signatures will be introduced to avoid the risk of subsequent alteration.
- 2.4 Where documents are required to be retained, the company must hold the relevant electronic form documents at its registered office.

- 2.5 Where shareholders were entitled under the Previous Code to inspect and copy documents, the Revised Code allows shareholders to demand inspection and receipt of a copy of the relevant information in electronic form. In addition, where shareholders were entitled under the Previous Code to demand delivery of copies of corporate documents, shareholders may, if an electronic record has been produced under the Revised Code:
- (A) require the company to provide the information concerned in electronic form; and
  - (B) demand delivery of a hard copy of the information held in electronic form.

### **3. Exercise of voting rights at shareholders' meetings**

- 3.1 The Previous Code allowed the exercise of voting rights by written submission only in respect of companies with issued share capital of JPY500 million or more or liabilities of JPY20 billion or more ("Large Companies") with more than one thousand shareholders holding voting rights. The Revised Code now permits the exercise of voting rights in writing in respect of any company, if so approved by the company's board of directors.
- 3.2 In addition, if the company's board has passed a resolution approving the exercise of voting rights in writing, shareholders who are not present at a general meeting of shareholders may exercise their voting rights electronically if this voting method been approved by the company. It is anticipated that allowing the exercise of voting rights electronically will reduce management costs, as well as making it easier for the requisite quorum to be obtained in shareholders' meetings. Shareholders also benefit through increased opportunities to exercise their rights.

#### **4. Disclosure of financial statements**

The Revised Code allows companies, following board approval, to use electronic technology – for example, company websites – to disclose their financial statements, including their balance sheets, to the general public for five years from the date of approval of the financial statements in shareholders' meeting.

This system replaces the previous requirement that companies give public notice of their financial statements (or a summary of their financial statements). It effectively reduces the burden on the company while at the same time enhancing the disclosure of financial statements.

## Part C: Corporate governance

### 1. Indemnification of directors

- 1.1 Under the Previous Code, it was not possible for directors or statutory auditors to be indemnified against liability unless all shareholders were in agreement.

Under the Revised Code, liability may be limited through:

- (A) indemnification by a special resolution passed in shareholders' meeting;
- (B) indemnification by a resolution of the board of directors if this is provided for under the Articles of Incorporation; or
- (C) indemnification by a liability limitation agreement entered into between the company and an external director<sup>1</sup>.

The limitation of liability set out in paragraph (C) is not, however, available in respect of external auditors.

- 1.2 It is not possible to indemnify directors against liability under Section 266.1.5 of the Commercial Code (for non-compliance with legislation relating to directors' duties (including the breach thereof) or the company's Articles of Incorporation) unless it can be shown that the director acted in good faith and without gross negligence. It is not possible under any circumstances to indemnify directors against other statutory liabilities to the company under Sections 266.1.1-4 of the Commercial Code (which cover matters such as the making of illegal distributions, conflicts of interest and offers of benefit only to certain shareholders).
- 1.3 The maximum amount of liability which can be incurred by a director where liability is limited in accordance with the Revised Code is as follows:

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<sup>1</sup> The December Amendment defines "external director" as a director who is not currently, nor has ever been, engaged in the administration of the business of the company or any of its subsidiaries whether as director, officer or other employee.

Post	Maximum Amount (A + B + C)		
	A	B	C
Representative Director	Six years' remuneration	The lower of: – the director's total retirement allowance amount ("TRA"); and – $\frac{\text{TRA} \times 6 \text{ years}}{\text{No. of years service}}$	Any profits made from the exercise of share options
External Director	Two years' remuneration	The lower of: – TRA; and – $\frac{\text{TRA} \times 2 \text{ years}}{\text{No. of years service}}$	Any profits made from the exercise of share options
Other Director	Four years' remuneration	The lower of: – TRA; and – $\frac{\text{TRA} \times 4 \text{ years}}{\text{No. of years service}}$	Any profits made from the exercise of share options
Statutory Auditor	Two years' remuneration	The lower of: – TRA; and – $\frac{\text{TRA} \times 2 \text{ years}}{\text{No. of years service}}$	Any profits made from the exercise of share options

## **2. Derivative actions**

### **2.1 Extension of period for consideration**

Under the Previous Code, where a shareholder who held shares in the company for a continuous period of six months or longer requested the company to bring a derivative action against a director to pursue his liability to the company, the statutory auditors had thirty days to consider whether or not to bring the action on the company's behalf. Under the Revised Code, this period has been increased to sixty days.

### **2.2 Procedural rules**

- (A) The Revised Code provides that where a company brings an action against a director or the company is given notice of an action by a shareholder bringing a derivative action against the company, it must immediately give public notice, or notice to its shareholders, of the action.
- (B) The Revised Code establishes that Section 266.5 of the Commercial Code is not applicable where the company reaches an out-of-court settlement in a liability action against a director. As a result, the approval of shareholders representing all of the issued shares in the company is not required in order to indemnify the director against liability.
- (C) The Revised Code also provides that a company may participate in a derivative action as an ancillary participant to support a defendant director. However, the approval of each of the company's statutory auditors is first required.

## **3. Strengthening the role of statutory auditors**

- 3.1 In addition to providing for limitations on the liability of directors and statutory auditors and amending the derivative action procedures, the Revised Code also strengthens the role of statutory auditors in order to ensure effective corporate governance.

**(A) Duty to attend board meetings and state opinions**

The Revised Code imposes a duty on statutory auditors to be present at board meetings and to state their opinions whenever necessary. This is a development from the Previous Code, which stated that statutory auditors had the right, as opposed to a duty, to attend board meetings and state their opinions.

**(B) Term of office**

In order to enhance the independence of statutory auditors, the term of office for statutory auditors has been extended from three to four years under the Revised Code.

**(C) Right to state opinions at time of resignation**

A statutory auditor or external statutory auditor who resigns is entitled under the Revised Code to attend the first shareholders' meeting following his resignation and announce the fact of his resignation together with his reasons for resigning. This provision is intended to discourage statutory auditors from resigning, as currently many statutory auditors resign under agreements reached with directors or are forced by directors to resign midway through their term of office.

**(D) External auditors**

Under the Previous Code, Large Companies were required to have at least one external statutory auditor. Under the Revised Code this has been increased, so that now at least one half of a Large Company's statutory auditors must be "external auditors".

In addition, the definition of external statutory auditors has been tightened. Under the Previous Code, the definition of external statutory auditor allowed a person to act as a company's external statutory auditor even if he had previously been a director, officer or

manager of the company or one of its subsidiaries providing that five years had elapsed since his retirement from the position. The Revised Code now states that no person who has held such a position within the company or one of its subsidiaries may act as external statutory auditor to the company, no matter how much time may have passed since his retirement from the position.

**(E) Right to consent to and propose the appointment of statutory auditors**

Under the Revised Code, the directors of Large Companies must obtain the approval of the board of statutory auditors before submitting a proposal to a shareholders' meeting for the appointment of a new statutory auditor.

In addition, the board of statutory auditors is now entitled to request the board of directors to appoint a statutory auditor at a shareholders' meeting. The board of statutory auditors may also itself submit a proposal for the appointment of a statutory auditor.

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