

Memorandum on the amended Sub-contract Act of Japan

[Translation]

1. **Introduction**

1.1 **Purpose of the Memorandum**

This memorandum aims to set out an overview of the amended Sub-contract Act (full title: the Act Against Delay in Payment of Sub-contract Proceeds etc. to sub-contractors, hereinafter the "Act") which came into force in Japan on 01 April 2004. The amended Act significantly extends its scope and is expected to effect a substantial number of companies engaged in business in Japan. It is therefore essential that all companies are made aware of the basic principals of the amended Act.

1.2 **Background of the amendment**

The Act was first enacted in 1956 as a special law of the Anti-monopoly Act which regulates anti-competitive conduct such as the abuse of a dominant position. The aim of the Act was to prevent delays in payments by principals to sub-contractors and to level out the bargaining powers between principals and sub-contractors when entering into sub-contracting arrangements. The Act identified specific types of abuse of dominance arising within sub-contracting arrangements and sought to simplify the procedures of regulation and enforcement.

The supervising authorities under the Act are the Fair Trade Commission (the "FTC") and the Small and Medium Sized Enterprises Agency (the "SME").

1.3 **2003 Amendment**

The 2003 amendment is intended to extend the scope of transactions to which the Act applies in order to reflect developments in the service and technology industries. The amendment also reinforces the enforcement provisions of the Act.

All transactions entered into after 01 April 2004 will be subject to the provisions of the amended Act, whereas transactions entered into prior to 01 April 2004 will only be subject to the original Act¹. Where individual agreements are executed under a master agreement, the relevant date (and governing Act) shall be determined based on the date of the individual agreement for the specific transaction.

Please note that this memorandum is based upon information available as at 01 April 2004 and is subject to update.

¹ Exception: the provisions raising the maximum level of fines came into force on 18 July 2003.

2. **The Amended Sub-Contract Act**

2.1 **Overview**

The basic principle of the Act is that it only applies to certain types of commissioning contracts specified in the Act. In addition, there are issued share capital thresholds for both the principal and the sub-contractor which also determine whether they are relevant parties to which the Act applies.

Where the Act applies, the principal of the relevant commission is placed under certain obligations and prohibited from certain conduct.

[Note: provisions introduced or amended by the 2003 amendment to the Act are *italicised*.]

2.2 **Relevant transactions**

The following types of commissions come within the scope of the Act: (A) manufacturing commissions, (B) repairing commissions, (C) commissions for the production of information deliverables and (D) commissions for the provision of services.

(A) **Manufacturing commissions (including commissions for the manufacture of moulds (*added by the 2003 amendment*))**

A “manufacturing commission” is defined in the Act as the commission by a principal of a sub-contractor for:

- (1) the manufacture (including processing, same definition applies hereafter) of articles, semi-finished components, parts of articles, accessories or materials of articles, or moulds when the principal sells the articles in the ordinary course of its business;
- (2) the manufacture of articles, semi-finished components, parts of articles, accessories or materials of articles, or moulds used for the manufacture of the foregoing items when the principal manufactures the articles in the ordinary course of its business;
- (3) the manufacture of parts of articles or materials of articles which are necessary for the repair of articles when the principal repairs the articles in the ordinary course of its business; or
- (4) the manufacture of articles, semi-finished components, parts of articles, accessories or materials of articles, or moulds when the principal manufactures the articles for its own use or consumption in the ordinary course of its business.²

² An example of this type of manufacturing commission would be where a machine manufacturer, which manufactures the machines it uses for its own business, commissions the manufacture of the machine or parts of the machine to a sub-contractor.

(B) Repairing commissions

A “repairing commission” is defined in the Act as the commission by a principal of a sub-contractor for:

- (1) all or part of the repair of articles when the principal repairs the articles in the ordinary course of its business under commission from a third party; or
- (2) a part of the repair of articles when the principal repairs the articles for its own use in the ordinary course of its business.

(C) Commissions for the production of information deliverables (*added by the 2003 amendment*)

A “commission for the production of information deliverables” is defined in the Act as the commission by a principal of a sub-contractor for:

- (1) all or part of the production of any information deliverables when the principal provides the information deliverables to third parties in the ordinary course of its business; or
- (2) all or part of the production of any information deliverables when the principal produces the information deliverables under commission from a third party
- (3) all or part of the production of any information deliverables when the principal produces the information deliverables for its own use in the ordinary course of its business³.

(a) An “information deliverable” is defined as:

- (i) a programme (e.g. game software and accounting software);
- (ii) a film, broadcast programme, other images or contents comprising audio signals and other types of sounds (e.g. movies, TV programs);
- (iii) letters, figures, symbols or contents comprising a combination of these or combining these with colours (e.g. designs or plans of a product, advertisements and consulting reports); or
- (iv) other contents similar to item (i) to (iii) above to be defined by a Government ordinance (to date there has been no indication of the likely scope of this provision).

(b) “Provision to third parties”

For the purposes of the Act, a principal is considered to be providing information deliverables to a third party when a principal provides such

³ An example of where a principal may be considered to be producing information deliverables for use by itself in the ordinary course of its business is where a principal business software developer commissions another software developer to develop part of its in-house accounting software for use by the principal.

information deliverables to a third party by way of, for example, sales or licensing.

This includes cases where the principal provides the information deliverables as an accessory or attachment to a product, as an incorporated part of a product, or when the information deliverable is a design the principal provides the design of manufactured product.

The Act will not apply to the commission for the production of information deliverables carried out by the sub-contractor on the principal's behalf free of charge.

- (c) When the principal only commissions the provision of services to be used for the production of information deliverables of a sub-contractor, such commission (for the provision of services) is not considered a commission for the production of information deliverables. In addition, as services commissioned for the principal's own use do not fall within the scope of commissions for the provision of services under the Act, the Act will not apply to such commissions.

(D) Commissions for the provision of services (*added by the 2003 amendment*)

For the purposes of the Act, "commissioning the provision of services" is defined as the commissioning by a principal of a sub-contractor to carry out (all or a part of) the provision of services which are provided by the principal to a third party in the ordinary course of its business.

- (a) The scope of services is not defined, therefore the Act will apply to all services unless otherwise provided⁴.
- (b) The Act applies to the provision of services where the services are to be provided by a sub-contractor on behalf of the principal to a third party. Services commissioned for the principal's own use do not apply.
- (c) The Act will not apply to the provision of services which are provided by the sub-contractor to a third party on the principal's behalf free of charge. However, if the services are provided as an integral part of a product or service which the principal charges the third party for, the Act will apply to such a commission.

2.3 Relevant parties (Article 2)

- (A) The commissions above fall within the scope of the Act when the following thresholds are met.
 - (1) In respect of manufacturing commissions, repairing commissions and commissions expressly excluded from item (2) below:

⁴ The act expressly excludes the case of a building constructor commissioning another constructor for the provision of construction services.

- (a) any legal entity (“principal”) whose issued share capital exceeds JPY 300 million and who commissions a legal entity whose issued share capital is not more than JPY 300 million or an individual (“sub-contractor”); or
 - (b) any legal entity (“principal”) whose issued share capital exceeds JPY 10 million but is not more than JPY 300 million and who commissions a legal entity whose issued share capital is not more than JPY 10 million or an individual (“sub-contractor”).
- (2) In respect of commissions for the production of information deliverables (except commissions for the production of programmes) and commissions for the provision of services (except transportation, storage and information processing commissions):
- (a) any legal entity (“principal”) whose issued share capital exceeds JPY 50 million and who commissions a legal entity whose issued share capital is less than JPY 50 million or an individual (“sub-contractor”); or
 - (b) any legal entity (“principal”) whose issued share capital exceeds JPY 10 million but is not more than JPY 50 million and who commissions a legal entity whose issued share capital is not more than JPY 10 million or an individual (“sub-contractor”).

(B) Conduit companies

A principal cannot avoid the application of the Act by using a conduit company to commission a sub-contractor⁵. If the commission falls within the scope of transactions to which the Act applies and the parent company satisfies the relevant party thresholds, the contracting subsidiary/conduit company will be deemed to be the principal in the sub-contracting arrangement (despite its failure to meet the relevant threshold) and will be caught within the provisions of the Act.

(C) Group companies

The Act also applies to transactions between group companies or affiliates. However, the FTC has indicated that it will, in practice, not enforce the Act in respect of intra-group transactions.

2.4 Obligations imposed upon the principal

Where a sub-contracting commission falls within the scope of the Act, the principal is obliged to:

⁵ A conduit company is a company: (1) whose officers may be appointed and dismissed by its parent company, or whose conduct or existence in business is controlled by its parent company; and (2) who receives a commission from the parent company and then grants a re-commission of the whole or a considerable part thereof to a sub-contractor.

- (A) immediately⁶ deliver a written statement to the sub-contractor which sets out all necessary matters pertaining to the sub-contract⁷⁸;
- (B) prepare and store records, for a period of two years, expressly setting out the work commissioned to the sub-contractor, payment and other matters (Article 5)⁹¹⁰;
- (C) fix the date of payment of consideration owing to the sub-contractor as a date which is as short as possible and at longest within 60 days of receipt of the commissioned work or in respect of services, of the date on which the services were provided (Article 2.2); and
- (D) pay default interest (14.6% per annum) on any amounts owing to the sub-contractor which are not settled within 60 days of receipt of the commissioned work, or in respect of services of the date on which the services were provided (Article 4.2), until the date that actual payment is made.

In respect of item (A) above, the Act requires that all necessary information relating to the sub-contracting arrangement be provided immediately by the principal to the sub-contractor in writing.

However, where there exists a justifiable reason for not having determined the terms of the sub-contracting arrangement at the time of the commission, there is no obligation on the principal to set out the terms in writing at this time (*added by the 2003 amendment*)¹¹. In such cases, the principal must at the time of commission set out in a written document (1) the reasons for not being able to determine such required matters and (2) the date by which it is expected that such matters will be determined.

Accordingly, the principal may postpone delivery of the written statement until the terms of the commission are determined. Upon determining the necessary terms of the commission, the principal must immediately deliver the necessary written documentation to the sub-contractor, and state clearly the relationship between the previously-delivered documentation and the newly-delivered documentation.

2.5 Prohibited conduct by principals (Article 4)

Where a sub-contracting arrangement falls within the scope of the Act, the following conduct by principals is prohibited:

⁶ "immediately" has been interpreted literally to mean at the time of the commission. Even if a formal agreement has not been entered at the time of the commission, a written document setting out the required terms must be provided.

⁷ The matters which must be included in such written statement are set out in Schedule 1.

⁸ Written statements may be issued electronically in certain circumstances set out in Schedule 3 Section 1.

⁹ The matters which must be included in the records are set out in Schedule 2.

¹⁰ These records may be stored electronically if the requirements set out in Schedule 3 Section 2 are satisfied.

¹¹ "justifiable reason" means that it is objectively impossible for the parties to determine the prescribed matters at the time of the commission due to the nature of the commission.

- (A) unreasonable refusal to accept delivery of the sub-contractor's work;
- (B) failure to settle payments to the sub-contractor once such payment has fallen due;
- (C) unreasonable reduction of the amount of consideration payable to the sub-contractor;
- (D) unreasonable return of the work product to the sub-contractor;
- (E) unreasonable imposition of extremely low levels of consideration upon the sub-contractor in comparison to amounts ordinarily paid for the same or a similar work;
- (F) unreasonably obliging the sub-contractor to purchase specified articles or raw materials or to use certain services designated by the principal when carrying out its commission (*use of services prohibition added by 2003 amendment*);
- (G) taking steps against the sub-contractor in retaliation for any reports made by the sub-contractor to the FTC or the Director-General of the SME relating to a violation by the principal of the Act;
- (H) forcing a sub-contractor to pay the whole or a part of the costs of any raw materials purchased from the principal or setting off such costs against the consideration due to the sub-contractor, before the date of payment by the principal to the sub-contractor of the consideration due for the work for which the raw materials are used;
- (I) making payment by way of promissory notes or other commercial paper which are not straightforward to exchange (the due date must be within 120 days of the issue (the period is 90 days in the textile industry));
- (J) demanding unfair economic conditions such as monies or provision of services or any other economic interests (*added by the 2003 amendment*)¹²; and
- (K) unreasonably altering the terms of the commission granted to the sub-contractor or requesting unfair re-work after the receipt of the work product (*added by the 2003 amendment*)¹³.

2.6 Sanctions imposed on principals for violations of the Act

In the event that the FTC or the Director General of the SME has reason to suspect that a principal is in breach of the Act, the following measures may be taken.

¹² This is defined in the Act as where the principal, for any reason whatsoever including sponsorship, demands the sub-contractor to provide any economic interests such as money or free labour services to the principal irrespective of the payment of the consideration pursuant to the terms of the sub-contracting arrangements. The principal risks breaching this provision unless it clearly states the benefits to the sub-contractor in respect of providing such economic interest.

¹³ Whether or not the terms of the commission have been altered will be determined according to the written statement issued at the time of the commission. Furthermore, an unreasonably harmful situation will not arise where the principal pays additional consideration for the costs of the extra work or negotiates in good faith with the sub-contractor.

(A) Reporting and inspection (Article 9)

The FTC or the SME may order the principal or the sub-contractor to file a report on its transactions, and/or may order its officials to enter an office or place of business of the principal or the sub-contractor to perform an inspection thereof.

(B) Investigation by the SME (Article 6)

The SME may investigate the alleged breach and refer this to the FTC for measures to be imposed upon a principal found to be in breach of its obligations under the Act.

(C) FTC Recommendation (Article 7)

If the FTC finds the principal is in breach of the Act, it may issue recommendations to the principal. A recommendation may recommend the cessation of the violating conduct, restoration to its original condition and/or taking any necessary measures¹⁴. The FTC may also at its discretion publish its recommendations (*added by the 2003 amendment*).

(D) Fines (Articles 10 – 12)

A maximum fine of JPY 500,000 can be imposed by a court where the principal (*maximum fine level has been raised by the 2003 amendment*)¹⁵:

- (1) has failed to deliver a written statement to the sub-contractor at the time of commission;
- (2) has failed to prepare or store the required documents setting out the scope of work, the date of receipt of work, the date of payment of consideration to the sub-contractor, and other matters as required by law (see Schedule 2);
- (3) fails to file with the FTC a report requested by the FTC or the Director-General of the SME or files a false report pursuant to such request; or
- (4) refuses, disrupts or evades an inspection by the FTC.

The FTC only has the powers set out above. It does not have the power to award compensation to a sub-contractor or to order a principal to pay such compensation to a sub-contractor.

¹⁴ The recommendations which could be made by the FTC under the original Act were limited. Under the amended Act, the FTC may issue any recommendations necessary to tackle the breach, including preventative measures to stop reoccurrence of the same violation.

¹⁵ Where the principal is a company, fines may be levied against both the employer and employees. In this instance, any employee with the delegated power to represent the company could be held liable for fines imposed by the FTC.

3. **Other matters**

(A) **FTC annual questionnaires**

Although any person is entitled to make a complaint against a principal, whether interested in the sub-contractor or otherwise, complaints are rarely made in practice. From the perspective of sub-contractors, their business often depends on the principal and they are often not in a commercial position to file complaints with the FTC. This makes it difficult for the FTC to detect breaches of the Act.

To this regard, the FTC maintains a list of principals and issues annual questionnaires to principals requesting details of their sub-contracting arrangements and their compliance with the Act. The FTC also sends a separate questionnaire to known sub-contractors requesting the same details. Most breaches are identified as a result of these questionnaires.

(B) **International transactions**

Where one party to a sub-contracting arrangement is an overseas entity, the Act will only apply where the sub-contractor is a Japanese entity.

(C) **Guidelines**

The FTC has issued detailed guidelines in relation to the relative transactions and obligations imposed on principals. The guidelines are only issued in Japanese, however could be translated into English for clarification purposes upon request.

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TMI Associates in association with Simmons & Simmons

SCHEDULE 1 : MATTERS WHICH MUST BE EXPRESSED IN WRITING AT TIME OF THE COMMISSION

Matters which must be expressed in writing and provided by the principal to the sub-contractor in a sub-contracting arrangement at the time of commission include:

- (A) the names of the principal and the sub-contractor
- (B) the date of the commission;
- (C) contents of the work commissioned (in the case of commissions for the provision of services, the date on which or the term during which the service will be provided);
- (D) the date and place of receipt of the work;
- (E) the inspection completion date in the event that the principal is to inspect the work;
- (F) payment information, including the amount of consideration and the date of payment;
- (G) where payment is made by way of commercial paper, the amount and payment date of such; and
- (H) where the principal purchases and supplies raw materials to the sub-contractor, details of the raw materials, the quantity, price, delivery date and settlement date and methods in respect of such supply of raw materials.

If a written document such as a basic agreement has been provided by the principal to the sub-contractor in which the necessary information is set out, a principal is not required to provide separate documentation for each individual commission which falls within the terms of the basic agreement. However, the principal is required to expressly state the relationship between the documentation issued for the individual commission and the basic agreement previously delivered to the sub-contractor. For example, the documentation provided by the principal for the individual commission should state “the method of payment of the consideration under the sub-contract shall be in accordance with the terms of the written agreement dated []”.

SCHEDULE 2: MATTERS WHICH MUST BE EXPRESSED IN WRITING IN THE DOCUMENTS TO BE STORED

Main matters to be expressed in writing in the documents to be prepared and stored by the principal include:

- (A) the names of the principal and the sub-contractor;
- (B) the date of the commission;
- (C) contents of the work commissioned (in the case of commissions for the provision of services, the date on which or the term during which the service will be provided);
- (D) the date and place of delivery of the work;
- (E) the date and contents of the work received;
- (F) the inspection completion date, result of the inspection and treatment of the work failed in the inspection in the event that the principal inspected the work;
- (G) where any alterations or re-work of the commissioned work has taken place, details of the alterations/re-work and the reasons for such;
- (H) the amount of consideration and the date of payment;
- (I) where alterations had been made to the amount of consideration, the amount of any increase or decrease, as well as the reasons for the increase/decrease;
- (J) the amount of consideration paid, the date of payment and the methods of payment;
- (K) where payment had been made by way of commercial paper, the amount of payment, the date of payment and the due date;
- (L) where the principal purchases and supplies raw materials to the sub-contractor, details of the raw materials, the quantity, price, delivery date and settlement date and methods in respect of such supply of raw materials;
- (M) where deductions had been made from the agreed amount of consideration (e.g. early payment or settlement for the purchase of raw materials), the amount of consideration after the deduction; and
- (N) where the principal paid any default interest, the amount and date of such payment.

SCHEDULE 3: REQUIREMENTS FOR USING ELECTRONIC METHODS

1. **Statements issued at the time of commission may be issued electronically if:**
 - (1) the consent of the sub-contractor is obtained, either in writing or electronically;
 - (2) the principal informs the sub-contractor of the method of providing and recording the information to the sub-contractor;
 - (3) the principal provides the information by one of the prescribed methods; and
 - (4) the sub-contractor is able to print the information.

2. **Records to be prepared and stored in respect of the sub-contracting commission may be prepared and stored electronically if:**
 - (1) any revisions are easily recognisable;
 - (2) it is possible to review the information, either on screen or on paper; and
 - (3) a search function is available allowing a search by subject (e.g. name of the sub-contractor) or date.