

(Reference Translation)

Supplementary Explanations to the  
Interim Proposal concerning Revision of Companies Act

December 2011

Counselor's Office, Civil Affairs Bureau, Ministry of Justice

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Note from Tokyo Stock Exchange:

Capitalized terms used but not defined in this Interim Proposal have the meanings assigned to them in the Companies Act or Financial Instruments and Exchange Act in Japan. For Example, "Public Company" is not limited to listed company but include any Stock Company the Articles of Incorporation of which do not require, as a feature of all or part of its shares, the approval of the Stock Company for the acquisition of such shares by transfer.

## **Introduction**

On December 7, 2011, the Companies Act Subcommittee (the “Subcommittee”) (Subcommittee Chair: Professor Shinsaku Iwahara, The University of Tokyo) of the Legislative Council of the Ministry of Justice, which is an advisory body to the Minister of Justice, completed its “Interim Proposal concerning Revision of Companies Act (the “Interim Proposal”).”

More than five years have elapsed since the May 2006 implementation of the Companies Act, which was enacted in 2005, and it can be said that its practical application has become quite firmly established.

Nevertheless, with respect to corporate governance, it has been suggested that a review is needed of the audit and supervision functions of the board of directors, which constitutes the management of a company, including the necessity of utilizing the functions of outside parties not under the influence of management. (Recently, cases have been reported in the media that question the effectiveness of corporate governance in Japan.)

The point has also been raised that the rules concerning parent and Subsidiary companies are in need of review and, as reflected in the Diet deliberations on the Companies Act bill, in the voting of the Committees on Judicial Affairs of both the House of Councillors and the House of Representatives, where supplemental resolutions were introduced calling for the examination of business combinations legislation, specifically, the rules concerning parent and Subsidiary companies, the need to update the legislation is a matter of continuing discussion.

Given these concerns, at the 162<sup>nd</sup> meeting of the Legislative Council of the Ministry of Justice held on February 24, 2010, the Minister of Justice at the time, Keiko Chiba, posed the inquiry (Inquiry No. 91) to the Council stating, “In view of the important social and economic roles of companies and from the perspective of maintaining the greatest possible level of confidence among the broad scope of persons who have an interest in companies, there is need to review the state of corporate governance and the rules, etc., concerning parent and Subsidiary companies and I would like the Council to develop guidelines.” The Subcommittee was established in the Legislative Council of the Ministry of Justice in response to this.

The deliberations of the Subcommittee began from April 2010. Due to the impact of the Great East Japan Earthquake, deliberations were suspended from March through the first part of July of 2011, but were recommenced from the last part of July. At the 16<sup>th</sup> meeting of the Subcommittee convened on December 7, 2010 the Interim Proposal was completed and approval was given for release by the Counselor’s Office of the Civil Affairs Bureau of the Ministry of Justice, which is the office in charge, and for commencement of the process of public comment.

Accordingly, the Interim Proposal is to be released by the Counselor’s Office of the Civil Affairs Bureau of the Ministry of Justice and the process of public comment begun.

As the next step, the Subcommittee, upon receipt and review of the opinions received with respect to the Interim Proposal, will continue its deliberations with the aim of preparing proposed guidelines for the revision of the current Companies Act with respect to the operation of corporate governance and the rules concerning parent and Subsidiary companies, etc. (The timetable for the completion of the proposed guidelines and the submission of legislation has not yet been finalized.)

These Supplementary Explanations have been prepared for the purpose of providing additional background on the purport and intent behind the matters addressed in the Interim Proposal by referring to the course of the deliberations of the Subcommittee with the hope that this will ensure a

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fuller understanding of the Interim Proposals when they are released to the public. These Supplementary Explanations have been prepared by the Counselor's Office of the Civil Affairs Bureau of the Ministry of Justice, which is solely responsible for its content.

## **Part 1 Corporate Governance**

### **I. Supervisory Function of Board of Directors**

#### **1. Obligation to Appoint Outside Directors**

(1) From the perspective of improving the supervisory role of the Board of Directors, Chapter I, Sections 1 and 2 of the Interim Proposal address plans for utilizing Outside Directors.

The comment has been made in recent years that Outside Directors should be utilized; and from the perspective of enhancing the supervision of the Board of Directors, the following in particular can be expected as functions relating to supervision of management held by Outside Directors having the right to vote in resolutions of the Board of Directors.

##### **i. Supervisory Function over Overall Management**

(a) Supervisory function over overall management through the exercise of voting rights, etc., with respect to decisions on important matters by the Board of Directors

(b) Supervisory function over management through the exercise of voting rights, etc., with respect to decisions on the selection and dismissal of management by the Board of Directors based on evaluation of overall management (management evaluation function)

##### **ii. Supervisory Function over Conflicts of Interest**

(a) Supervisory function over conflicts of interest between the Stock Company and management

(b) Supervisory function over conflicts of interest between the Stock Company and stakeholders other than management

There are two potential directions that might be taken when considering the possible revision of current law for the purpose of better utilizing these functions of Outside Directors, namely, the application of rules to certain Stock Companies under current law, or allowing the design of a new corporate organ to promote the functioning of Outside Directors.

(2) In Section 1, as a measure for utilizing the function of Outside Directors by revising the application of rules to certain Stock Companies under current law, the issue is addressed of whether or not to require certain Stock Companies to appoint Outside Directors.

In the Subcommittee, it was pointed out in regards to the management evaluation function and supervisory function over conflicts of interest expected of Outside Directors cited in Subsection (1) above, that management is in the position of being subject to supervision; therefore, whether or not to utilize these functions is not something that should be left to management's judgment, utilization of these functions should be compelled through legal rules, and this could serve as the grounds for requiring the appointment of Outside Directors.

On the other hand, it was also pointed out in the Subcommittee that because in a Company with Board of Auditors there must be at least three Company Auditors, the majority of which are Outside Company Auditors (Companies Act, Article 335(3)), requiring in addition to this that a Company with Board of Auditors elect Outside Directors would result in a duplication of functions between the two and constitute excessive regulation. It was also commented that uniformly compelling the election of Outside Directors risked hindering the formation of

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flexible corporate governance systems best suited to the size, business and type of operation of an individual Stock Company and that this would be an excessive burden on Stock Companies in terms of obtaining the human resources to serve as Outside Directors.

As a result of the divided opinion of the Subcommittee in regard to requiring the appointment of Outside Directors, Section 1 lists Proposals A and B, which require appointment, and Proposal C, which proposes no change to the rules under current law.

- (3) While both Proposals A and B require the appointment of Outside Directors, the number of Outside Directors in both proposals is one or more. The reasons for this are, first, although it was commented that, in order for Outside Directors to fulfill their functions of management evaluation and supervision over conflicts of interest, Outside Directors should comprise the majority of Directors, it was thought that given the current situation in Japan, requiring the appointment of a majority of Outside Directors was not practical; this was also based on the argument in the Subcommittee that even if there was only one Outside Director he/she could fulfill the supervisory function to a certain extent.

On the other hand, the scope of Stock Companies that would be required to appoint Outside Directors differs between Proposal A and Proposal B. Proposal A requires the appointment of Outside Directors by those Companies with Board of Auditors which are Public Companies (this means Public Companies as defined in Article 2(v) of the Companies Act; hereinafter the same) and are also Large Companies or, in other words, Stock Companies which are required under the Companies Act to have a Board of Auditors (Companies Act, Article 328(1)). This is because in the case of a Stock Company that is both a Public Company and a Large Company, it is thought that given both the possibility of change to their shareholder composition and their impact in view of their size, the need for supervision of management by Outside Directors is great and it is thought that in view of their size they can bear the costs related to securing the human resources to serve as Outside Directors.

In contrast to this, Proposal B would require that companies which submit securities reports pursuant to the provisions of Article 24(1) of the Financial Instruments and Exchange Act (excluding Companies with Committees and Companies with Audit and Supervisory Committee (this refers to a Company with Audit and Supervisory Committee as defined in Section 2 (1) below) appoint Outside Directors. This is based on the thinking that because such companies have many shareholders among the general public, shareholders cannot be expected to exercise management supervision and for this reason there is increased need for supervision exercised by Outside Directors.

Because Proposal A and Proposal B differ in how they set the scope of Stock Companies which would be subject to the requirement for election of Outside Directors, the two proposals have been separately listed in the Interim Proposal, but they are not viewed as mutually exclusive.

## **2. Companies with Audit and Supervisory Committee**

### **(1) Establishment of an Audit and Supervisory Committee**

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- a. Of the organizational designs permitted under current law, Companies with Board of Auditors are required to appoint at least two Outside Company Auditors (Companies Act, Article 335(3)); it was remarked that from the perspective of utilizing the roles of Outside Directors, this would not necessarily be an easy organizational design to apply, given the redundancy and burden that would be felt if, in addition to these Outside Company Auditors, Outside Directors also had to be appointed. It was also pointed out that due to the feeling of resistance in Companies with Committees about establishing Nominating Committees and Compensation Committees, Companies with Committees have not been widely used. Taking these points into consideration, Chapter I, Section 2 of the Interim Proposal allows for the design of a new corporate organ, an Audit and Supervisory Committee, as a plan for efficiently utilizing Outside Directors (see Section 1 (1) above.).

As stated in Section 1 (1) above, it is believed that Outside Directors have the function of evaluating management as well as a supervisory function over conflicts of interest. For that reason it could be expected that efficacy of supervision over management could be assured by means of Outside Directors fulfilling their supervisory functions through the exercise of voting rights, etc., with respect to resolutions of the Board of Directors.

Although Outside Directors would be involved in management decisions through the exercise of voting rights in the board of directors, if, because they would not themselves execute business, their involvement is limited to decisions on matters of major importance, through this involvement in management decisions, a supervisory function over management would be efficiently fulfilled.

Thus, Section 2, with the view that involvement in management decisions is of material significance in terms of supervising management, and for the purpose of utilizing the functions of Outside Directors, proposes the establishment of a system of Companies with Audit and Supervisory Committee, a new type of corporate organizational design, different from the current Companies with Board of Auditors and Companies with Committees. From the perspective of enhancing the supervisory function of the Board of Directors, this system aims to keep supervision separate from the execution of business through the appointment of multiple Outside Directors who do not themselves execute business; these Outside Directors would be responsible for supervision, and they would fulfill their supervisory function by participating in decisions concerning the selection and discharge etc., of management.

The note to the main text of Section 2 indicates that because matters such as the authority of the committee are involved, further consideration is required for the name of this new system.

- b. Subsection (1) of the Interim Proposal addresses the organizational structure of a Company with Audit and Supervisory Committee (“Company with Audit and Supervisory Committee”).

Item (i) sets forth that under the Companies Act, the question of whether or not a Stock Company will establish an Audit and Supervisory Committee is left for a company to

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decided in its Articles of Incorporation and allows for the establishment of an Audit and Supervisory Committee regardless of whether the company is a Large Company or whether it is a Public Company.

In Item (ii), given that the system of a Company with Audit and Supervisory Committee is a corporate organ design newly established from the perspective of improving the supervisory function of the Board of Directors, Companies with Audit and Supervisory Committee are obligated to establish a Board of Directors. At the same time, in Item (iii), because in a Company with Audit and Supervisory Committee the Audit and Supervisory Committee will be responsible for audits, such companies, in order to avoid redundancy of the audit function, will not have Auditors, a Nominating Committee, Audit Committee or Compensation Committee. It should be noted that while Companies with Audit and Supervisory Committee will not be precluded from voluntarily establishing committees having the names “Nominating Committee” or “Compensation Committee”, the rules (Companies Act, Article 404, et al.) governing the authority of those committees in a Company with Committees would not apply.

As discussed in Subsection (2) below, an Audit and Supervisory Committee will conduct organizational audits using what are called internal control systems in the same way as the audit committee of a Company with Committees; in the construction of internal control systems, the Accounting Auditor is expected to fulfill an important role from the perspective of ensuring the appropriateness and reliability of financial statements. Accordingly, Item (iv) provides that a Company with Audit and Supervisory Committee shall have an Accounting Auditor, regardless of whether or not it is a Large Company, as is the case with Companies with Committees.

Further, in view of the fact that a Company with Audit and Supervisory Committee will not have a Nominating Committee or a Compensation Committee, Item (v) provides that the person carrying out those functions will not be an Executive Officer elected by the Board of Directors but a Representative Director selected from among the Directors elected by resolution of the Shareholders Meeting or other Director prescribed in Article 363(1) of the Companies Act. It is for this reason that Item (vi) provides that unlike the Directors of a Company with Committees (see Article 331(3) of the Companies Act), the Directors of a Company with Audit and Supervisory Committee may concurrently hold a position in the same company as a Manager or other employee, provided they are not members of the Audit and Supervisory Committee (“Audit and Supervisory Committee Member(s)”).

## **(2) Composition and Authority, etc., of Audit and Supervisory Committee**

Subsection (2) of the Interim Proposal addresses the composition and authority, etc., of the Audit and Supervisory Committee.

Item (i) provides that the Audit and Supervisory Committee shall be composed of three or more members. Item (ii) provides that Audit and Supervisory Committee Members shall be Directors and that a majority of which shall be Outside Directors, as is the case with the

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Company Auditors committee of a Company with Committees, which is a corporate organ designed for the supervisory function of Outside Directors in the same manner as a Company with Audit and Supervisory Committee. Item (iii) provides that the provisions similar to those that prohibit Audit Committee Members from concurrently holding two posts in Companies with Committees (Companies Act, Article 400(4)) shall also be established with respect to Audit and Supervisory Committee Members.

Further, because the Audit and Supervisory Committee is composed of Directors it is envisioned that, as is the case for Audit Committee Members of a Company with Committees, organizational audits will be carried out using systems (internal control systems) necessary to ensure the properness of the Stock Company's business as decided by its Board of Directors. Accordingly, first of all, Item (v) provides that the Board of Directors of a Company with Audit and Supervisory Committee shall make decisions ensuring the maintenance of internal control systems in the same way as in Companies with Committees, regardless of whether or not it is a Large Company. In addition, it is prescribed in Item (iv) that the Audit and Supervisory Committee shall have the same authority as the Audit Committee of a Company with Committees and the Audit and Supervisory Committee Members shall have the same authority as the Audit Committee Members of a Company with Committees. In other words, the Audit and Supervisory Committee shall have as its duty supervision of Directors' performance of their duties and the preparation of audit reports (see Article 404(2)(i) of the Companies Act); and the Audit and Supervisory Committee Members selected by the Audit and Supervisory Committee shall have the authority, etc., to examine the business and financial conditions of the Company with Audit and Supervisory Committee and at the same time each Audit (see Article 405 of the Companies Act) and Supervisory Committee Member shall have the right to demand cessation of unlawful acts on the part of Directors (see Article 407 of the Companies Act). In regard to the question of whether or not to obligate the Audit and Supervisory Committee to select full-time Audit and Supervisory Committee Members from among the Audit and Supervisory Committee Members, from the perspective of audits using internal systems of control, as with the case of the Audit Committee in a Company with Committees, this is not made obligatory and the matter of whether or not to select full-time Audit and Supervisory Committee Members is left to the discretionary judgment of the Audit and Supervisory Committee itself. However, an opinion was expressed within the Subcommittee that, against the background of the practical awareness that full-time individuals among Company Auditors or Audit Committee Members fulfill an important role in the audit process, the selection of full-time Audit and Supervisory Committee Members should be obligatory. Taking into consideration the issue of consistency with an Audit Committee in a Company with Committees, which is not obligated to select full-time Audit Committee Members, and the way in which audits would be carried out by an Audit and Supervisory Committee, further study is required; accordingly, it was stated in the note to Item (v) that this point requires further consideration.

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In response to this, taking Companies with Board of Auditors as a point of reference, the comment was made in the Subcommittee that a majority of Audit and Supervisory Committee Members should be Outside Directors, that the selection of full-time Audit and Supervisory Committee Members should be obligatory and that also the Audit and Supervisory Committee (Members) should have the same authority as Board of Auditors (members). (In other words, Audit and Supervisory Committee Members, as auditors of the execution of business by Directors, should be given the authority to examine the business and financial conditions of a Company with Audit and Supervisory Committee (see in particular Article 381 of the Companies Act)). Because it could be said that this type of corporate organ design is substantially no different from allowing the Company Auditors of Companies with Board of Auditors to exercise voting rights at Board of Directors meetings, rather than permitting Companies with Audit and Supervisory Committee as a new corporate organ design, it can be stipulated in the Articles of Incorporation that Company Auditors may exercise voting rights at Board of Directors meetings.

With respect to the authority of Audit and Supervisory Committee, in light of the management evaluation function expected from Outside Directors (see Section 1 (1) above), Audit and Supervisory Committee Members selected by the Audit and Supervisory Committee could be permitted to state their views regarding the election of Directors at Shareholders Meetings, regardless of whether they are Directors who are Audit and Supervisory Committee Members or other Directors. Accordingly, Note 1 to Item (iv) states that this point requires further consideration.

Further, in light of the supervisory function over conflicts of interest (supervisory function over conflicts of interest between the Stock Company and its management) expected of Outside Directors (see Section 1 (1) above.), it could be concluded that Article 423(3) of the Companies Act, which provides for the presumption dereliction of duties by a Director, should not be applied in cases where the Audit and Supervisory Committee has agreed either before the fact or after the fact regarding conflict of interests transactions between the Stock Company and a Director. Accordingly, Note 2 to Item (iv) states that this point requires further consideration.

### **(3) Framework for Ensuring Independence of Audit and Supervisory Committee from Management**

The duty of the Audit and Supervisory Committee is to audit the execution of business by management; To ensure the effectiveness of its auditing, the Audit and Supervisory committee must be independent from management. As a framework for ensuring that independence of the Audit and Supervisory Committee from management, there are two possible models for the appointment and dismissal of Audit and Supervisory Committee Members— election by a Shareholders Meeting whereby the Shareholders Meeting elects Directors who are Audit and Supervisory Committee Members separately from other Directors and selection by the Board of Directors whereby Audit and Supervisory Committee Members are selected by resolution of the Board of Directors.

Regarding this point, in view of the fact that a Company with Audit and Supervisory Committee will not have a Nominating Committee or a Compensation Committee, in the case of selection by the Board of Directors, a framework could be established whereby, among other things, approval by a majority of the Outside Directors present would be required for a resolution of the Board of Directors regarding the selection of Audit and Supervisory Committee Members. However, regarding selection by the Board of Directors, within the Subcommittee there was comment that it should be further required that a majority of Directors shall be Outside Directors and other concerns were raised about the independence of Audit and Supervisory Committee Members from management. For that reason, in Subsection (3) of the Interim Proposal, from the perspective of ensuring the independence of the Audit and Supervisory Committee, election by Shareholders Meeting is adopted and a framework is provided that is modeled on the framework for ensuring the independence of Company Auditors.

In election by Shareholders Meeting the position of Audit and Supervisory Committee Member and the position of Director are one and the same, and it is assumed that the two will not be separated. The method for election and dismissal is modeled on the method for the election and dismissal of Company Auditors. First of all, in Item (i), regarding the election of Directors who are Audit and Supervisory Committee Members, it is stipulated that those Directors who are Audit and Supervisory Committee Members should be elected at a Shareholders Meeting separately from other Directors, and Items (ii) and (iii) grant to the Audit and Supervisory Committee the right of consent with respect to proposals for the election of Directors who are Audit and Supervisory Committee Members and the right to propose election-related agenda items and submit proposals. Furthermore, in Item (iv) the dismissal of a Director who is an Audit and Supervisory Committee Member is made subject to a special resolution of a Shareholders Meeting. In addition, Item (v) grants to each Audit and Supervisory Committee Member the right to state at a Shareholders Meeting his/her views in regard to the election and dismissal or resignation of a Director who is an Audit and Supervisory Committee Member and Item (vi) grants to a Director serving as an Audit and Supervisory Committee Member who has resigned the right to make state at a Shareholders Meeting regarding his/her resignation.

Next, in regards to the term of office of Directors who are Audit and Supervisory Committee Members, although on the one hand it was commented in the Subcommittee that from the perspective of ensuring the independence of Directors who are Audit and Supervisory Committee Members their term should be longer than other Directors, the opinion was also given that because they participate in management decisions a term identical to that of Company Auditors (four years) was too long. Therefore in Item (vii) the term of Directors who are Audit and Supervisory Committee Members is set at two years and that of other Directors one year. It should be noted that Article 459 of the Companies Act, as a special provision on organs that decide on dividends of surplus, etc., has as one requirement that the term of Directors be one year; if the term of Audit and Supervisory

Committee Members is made two years it may be necessary to make certain provisions so that Companies with Audit and Supervisory Committee would be subject to that special rule.

Furthermore, Item (viii) provides that the compensation etc. of Directors who are Audit and Supervisory Committee Members shall be determined separately from the compensation etc. of other Directors pursuant to the Articles of Incorporation or a resolution of the Shareholders Meeting and that when there is no provision in the Articles of Incorporation or a resolution of the Shareholders Meeting with respect to the compensation etc. of individual Directors, these matters shall be determined by deliberation of the Directors who are Audit and Supervisory Committee Members. Further, each Audit and Supervisory Committee Member shall be granted the right to state at Shareholders Meetings his/her views regarding the compensation etc. of Directors who are Audit and Supervisory Committee Members.

**(4) Decisions on Execution of Business at Board of Directors Meetings of Companies with Audit and Supervisory Committee**

From the perspective of enhancing the supervisory function of the Board of Directors, in order to fulfill the supervisory function by means of appointing multiple Outside Directors who do not themselves execute business so that supervision is kept separate from the execution of business and such Outside Directors participating in decisions concerning the appointment and discharge etc. of management, it is desirable that rather than having Outside Directors and other persons overseeing management be involved in all decisions concerning the execution of business, such persons should be able to concentrate on the supervisory function. From this point of view it would be appropriate that a Company with Audit and Supervisory Committee is allowed to delegate decisions on the execution of important business to Executive Officers to some extent and thus ensure adequate deliberation by the Board of Directors on those matters which are of particularly great importance.

Accordingly, the scope of execution of business with respect to which the Board of Directors in a Company with Audit and Supervisory Committee may delegate decisions to Directors may be made broader than the scope of execution of business with respect to which the Board of Directors in Company with (Board of) Auditors may delegate decisions to Directors under current laws. For that reason, Subsection (4) of the Interim Proposal, taking as a reference point those matters for which resolution by special Directors is allowed under current law (the main paragraph of Article 373(1) of the Companies Act), provides that the Board of Directors of a Company with Audit and Supervisory Committee may by resolution delegate to Directors decisions on the disposal or acquisition of important assets and borrowing in a significant amount (Article 362(4)(i-ii) of the Companies Act).

From the perspective of making it possible for persons overseeing management to concentrate on the supervisory function, there is room to permit the delegation of decisions to Directors on more matters than those for which resolution by special Directors is allowed. On this point, of the examples of important areas of execution of business listed in Article 362(4)(iii-vii) of the Companies Act, the appointment and dismissal of Managers etc. and

the establishment etc. of branch offices etc. in Item (iii) and Item (iv), cannot be called execution of operations regarding which it would naturally be expected that there would be supervision through involvement in the decision by Outside Directors, who are not necessarily well acquainted with the particulars of the business of the Stock Company; and it could also be said that important matters regarding the solicitation of subscribers to Bonds in Item (v) of the same paragraph have aspects similar to the borrowing in significant amount of Item (ii) of that same paragraph. On the other hand, within the Subcommittee comment was also made that because a Company with Audit and Supervisory Committee does not have a Nominating Committee or a Compensation Committee, decisions on the execution of important operations should be made carefully through deliberations of the Board of Directors and accordingly the broad delegation of such decisions should not be allowed.

Taking the foregoing into consideration, Note 1 to Subsection (4) states that the question of whether or not to delegate to Directors decisions on the matters listed in Items (iii-v) of Article 362(4) of the Companies Act requires further consideration. Additionally, Note 2 to Subsection (4) also states that the question of whether or not to allow the delegation to Directors of decisions on the execution of important operations (excluding the matters listed in Article 416(1) and (4) of the Companies Act, the decisions of which cannot be delegated to Executive Officers, hereinafter the same in this Section 2) other than the matters listed in Items (i-ii) of Article 362(4) (if the delegation of decisions on the matters listed in Items (iii-v) of Article 362(4) is allowed as discussed in Note 1 to Subsection (4), then including those items) under certain conditions requires further consideration. With respect to this point, because to further enhance the supervisory function of the Directors of Companies with Audit and Supervisory Committee, such delegation could be permitted, Note 2 (a) of Subsection (4) cites the majority of the Directors being Outside Directors as an example of the “certain conditions” alluded to above. Furthermore, because the scope of important operations the execution of which would require supervision through the careful deliberation by the Board of Directors of Companies with Audit and Supervisory Committee can be left to the shareholders to decide, in Note 2 (b) of Subsection (4), the existence of a provision in the Articles of Incorporation to the effect that decisions on execution of important operations may be delegated to Directors by a resolution of the Board of Directors is cited as another example of the “certain conditions” alluded to above.

### **3. Rules Concerning Outside Directors and Outside Company Auditors**

#### **(1) Treatment of Related Persons, etc., of a Parent Company in the Requirements for Outside Directors, etc.**

##### **A. Requirements for Outside Directors**

- i. Under current law an Outside Director is defined as a Director of any Stock Company who is neither an Executive Director nor an Executive Officer, nor an employee, including a Manager, of such Stock Company or any of its Subsidiaries, and who has not served in the past as an Executive Director, Executive Officer, nor as an employee,

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including Manager, of such Stock Company or any of its Subsidiaries (Companies Act, Article 2(xv)).

With respect to this definition, it was commented that from the perspective of increasing the effectiveness of the management supervisory function of Outside Directors the requirements for Outside Directors under current laws are insufficient, and what is necessary is the “independence” of having no interests in common with the management, specifically, of not being related persons of the Parent Company, related persons of important business counterparties or close relatives of management.

On the other hand, the point was raised in the Subcommittee that having a certain relationship with the Stock Company and its management, as in the case of related persons of the Parent Company and related persons of important business counterparties, could in fact serve to increase the effectiveness of supervision in terms of possessing the knowledge, experience and incentive, etc., for appropriate implementation of the supervisory function.

Due to this divided opinion within the Subcommittee in regards to revising the requirements for Outside Directors, Chapter I, Section 3 (1) of the Interim Proposal includes both Proposal A (i) for revising and Proposal B for not revising.

- ii. Proposal A (i) for revising the requirements of Outside Director in its subsection (a) adds to the requirements for Outside Directors not being a related person of the Parent Company of the Stock Company. The comment was made that in the context of the Parent Company being able to substantially decide on the selection and dismissal of management of the Stock Company (the Subsidiary) through the exercise of its voting rights in resolutions of Shareholders Meetings and thus being in a position of being able to exert influence on such management, there is therefore the typical and structural risk of such management pursuing the interests of the Parent Company and sacrificing the interests of the Stock Company. In relationship to the supervisory function over conflicts of interest (supervisory function over conflicts of interest between the Stock Company and stakeholders other than management) (see Section 1 (1) above) expected of Outside Directors, in a situation such as just outlined above it might not be possible to expect Directors who are related persons of the Parent Company to exercise effective supervision in the case of the management pursuing the interests of the Parent Company at the sacrifice of the interests of the Stock Company. Accordingly, Proposal A (i)(a) added to the requirements for Outside Directors their not being a Director or an Executive Officer, or a Manager or other employee, of the Parent Company of the Stock Company.

It may be noted that in Proposal A (i)(a), Accounting Advisors and Company Auditors of a Parent Company are not included among related persons of the Parent Company. The reason for this is that given that Directors of a Subsidiary of a Stock Company may not be Accounting Advisors of such Stock Company (Companies Act, Article 333(3)(i)), persons who are Accounting Advisors of the Parent Company may

not serve concurrently as Directors of a Subsidiary. The reason for not including Company Auditors is that given that they may not serve at the same time as Directors of a Subsidiary of the Stock Company (Companies Act, Article 335(2)), it is not allowed for persons who are Company Auditors of the Parent Company to serve concurrently as Directors of its Subsidiary.

Further, in Proposal A (i)(a) as a requirement pertaining to the period prior to assuming the position of Outside Director, it is not required that a person had never in the past been a related person of the Parent Company.

Turning to the question of whether, in addition to the Parent Company of a Stock Company, the related persons of other Subsidiaries (so-called sibling companies) of such Parent Company (excluding the subject Stock Company itself and its Subsidiaries) can be thought of in the same manner as related persons of the Parent Company, with sibling companies there are many sorts of potential relationships and further examination is necessary of whether it is appropriate to treat them uniformly. Therefore, as stated in Note 1 to Proposal A, this requires further consideration.

Next it was pointed out that Directors who are close relatives of managers or employees cannot be expected to effectively carry out the supervisory function over management and the supervisory function over conflicts of interest expected of Outside Directors (i.e., the supervisory function with respect to managers pursuing the interests of the managers themselves or of close relatives who have the same economic interests as the managers at the sacrifice of the interests of the Stock Company; see Section 1 (1) above). Accordingly, Proposal A (i)(b) adds to the requirements for Outside Directors that they may not be a spouse or a relative by blood within the second degree or relative by affinity within the second degree of a Director, an Executive Officer, or a Manager or other employee of the Stock Company (furthermore, as is the case in Subsection (i)(a), it is not a requirement pertaining to the period prior to assuming the position of Outside Director that the person never in the past have been a close relative of a manager etc.).

In addition to the above, the comment was made in the Subcommittee that not being a related person of an important business counterparty of the Stock Company should be added to the requirements for Outside Director. In response to this, it was pointed out in the Subcommittee that because the existence and degree of influence of an important business counterparty on the managers of a Stock Company depend to a large extent on the specific circumstances of the business and business relationships of the Stock Company, the question of whether there is a typical and structural risk of managers of a Stock Company pursuing the interests of the important business counterparty at the sacrifice of the interests of the Stock Company due to a related person of the important business counterparty being in a position to exert some influence over the managers needs to be carefully examined in relation to the supervisory function over conflicts of interest (see Section 1 (1) above). Also because

there are instances in which whether or not the requirements of Outside Director are met impacts on the validity of resolutions, etc., of the Board of Directors, if hypothetically not being a related person of an “important” business counterparty of a Stock Company was added to the requirements of an Outside Director, from the perspective of legal stability it would be necessary to make the criteria for “importance” clear and uniform. One example of the criteria for importance might be that the Stock Company’s sales to a counterparty were of a certain amount or more. However, even if sales, etc., of a Stock Company to a counterparty during one particular business year are great, the existence and degree of the influence of that business counterparty on the managers of the Stock Company are subject to changes in the circumstances of the business from time to time and are contingent on the substitutability of the counterparty and the degree of its negotiating power. For that reason further examination is required before deciding whether it is appropriate as a legal rule to define the scope of “important” business counterparties on the basis of uniform criteria such as a certain amount of sales, and make not being a related person of such a counterparty a requirement for Outside Directors.

In addition, comment was made that in terms of the supervisory function over overall management expected of an Outside Director (see Section 1 (1) above), from the standpoint that effective supervision could not be expected of Directors of a Stock Company who are related persons of an important business counterparty over managers of a Stock Company due to the possibility that such managers could exert influence over an important business counterparty, not being a related person of an important business counterparty of the Stock Company should be added to the requirements for Outside Directors. In regards to importance in this case, what needs to be examined is not whether the business counterparty is important to the Stock Company but rather whether the Stock Company is important to that counterparty; however, further careful consideration is needed in regard to the question of whether a Stock Company is able to judge its own importance to a particular counterparty or whether it is appropriate as a legal rule to define “importance” by means of uniform criteria such as amount of sales.

Taking into account the foregoing, Note 2 to Proposal A states that whether to add not being a related party of an important business counterparty of a Stock Company as a requirement for Outside Directors requires further consideration.

#### B. Requirements for Outside Company Auditors

Under current law, an Outside Company Auditor is defined as an auditor of any Stock Company who has neither served in the past as a Director, Accounting Advisor or Executive Officer, nor as a Manager or other employee of such Stock Company or any of its Subsidiaries (Companies Act, Article 2(xvi)).

In the Subcommittee comment was made that although there are differences in authority between a Director and a Company Auditor, if the requirements for being an Outside

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Director are revised, then the requirements for being an Outside Company Auditor should be similarly revised. Accordingly, in the Interim Proposal both Proposal A (ii), which calls for making revisions to the requirements for an Outside Company Auditor similarly as for an Outside Director, and Proposal B, which calls for making no changes to the rules under existing law, are put forth.

Proposal A (ii) (a) provides for adding to the requirements for Outside Company Auditors that they not be a Director, Company Auditor or Manager or other employee of the Parent Company of the Stock Company. Accounting Advisors of the Parent Company of the Stock Company are not listed; this is because, similarly with Proposal A (i) (a) in relation to the revision of the requirements for Outside Directors, the reason for not including Accounting Advisors is that Company Auditors of a Subsidiary of a Stock Company may not be Accounting Advisors of such Stock Company (Companies Act, Article 333(3)(i)). On the other hand, because a Company Auditor of a Parent Company is not prohibited from concurrently serving as Company Auditor of its Subsidiary (see Article 335(2) of the Companies Act.), unlike in Section (i) (a), Section (ii) (a) of Proposal A lists not being a person who is a Company Auditor of the Parent Company as a requirement.

Next Proposal A (ii) (b) adds to the requirements for Outside Company Auditors that they not be a person who is a spouse or relative by blood within the second degree, or a relative by affinity within the second degree of a Director or Manager or other employee of the Stock Company. Because Companies with Committees may not have Company Auditors (Companies Act, Article 327(4)), it is not a requirement for Outside Company Auditors to be a person who is not a close relative of an Executive Officer of the Stock Company.

As to the requirements pertaining to the period prior to assuming the position of Outside Company Auditor, it is not also provided that a person must never in the past have been a related person of the Parent Company or a close relative of management etc., of the Parent Company; this is also the case in Proposal A (i) with respect to the revision of the requirements for Outside Directors.

The question of how to treat related persons of sibling companies of a Stock Company in the requirements for Outside Company Auditors and whether or not to add the requirement that an Outside Company Auditor not be a related person of an important business counterparty, as stated In Notes 1 and 2 to Proposal A, as in the case of the requirements for Outside Directors, requires further consideration.

Under current law a Company with Board of Auditors shall have three or more Company Auditors, and at least half of them must be Outside Company Auditors (Companies Act, Article 335(3)), but the point was raised in the Subcommittee that in view of the fact that a considerable number of Companies with Board of Auditors appoint related persons of the Parent Company as Outside Auditors, if revisions are made to the requirements for Outside Company Auditors, consideration needs to be given to taking this aspect into account when establishing interim measures or the like.

## **(2) Limitations on the Period pertaining to the Requirements for Outside Directors, etc.**

Under current law, a person who even once in the past belonged to the management chain of command cannot meet the requirements for Outside Directors or for Outside Company Auditors (Companies Act, Article 2(xv, xvi). The background for this is that in 2001 Article 18(1) of the Act on Special Provisions of the Commercial Code Concerning Audits, etc. of Stock Companies provided in regards to the requirements for Outside Auditors that they “not be persons who were Directors or Managers or other employees of the company or its Subsidiaries during the period of five years prior to taking office”; however, many instances were seen of persons serving as Company Auditor subsequent to retiring as a Director and once five years had elapsed becoming an Outside Company Auditor; and the point was raised that because of this the intended objectives of the Outside Auditor system were not being adequately achieved; therefore with the revision of that act by Act No. 149 of 2001, the five-year limitation with respect to the subject period was eliminated and this was not changed at the time of the enactment of the Companies Act in 2005.

At the same time, however, it has been commented that even if a person was at one time in the management chain of command, if the relationship with the Stock Company or its Subsidiaries is subsequently terminated for a certain period and the relationship with its management weakens, such person can thus conceivably become qualified to effectively carry out the functions expected of an Outside Director, etc.; therefore leeway should be allowed, so that persons who at one point in time could not meet the requirements for Outside Directors, etc., to again qualify as Outside Directors, etc., by making the disqualifying period not the entire period prior to assuming office as an Outside Director, etc., but rather a certain period prior to assuming office (i.e., limiting the time period subject to this requirement for Outside Director, etc.). Also if the requirements for Outside Directors, etc., are revised by adopting Proposal A in Subsection (1), consideration must also be given to the demands, etc., of securing the human resources for Outside Directors, etc.

In view of the foregoing, Chapter I, Section 3 (2) of the Interim Proposal proposes that in the case that Proposal A in Subsection (1) is adopted and the requirements for Outside Directors, etc., are revised, taking into account the background of the revision discussed in the preceding paragraph and on the premise of also taking measures to prevent circumvention of the rules concerning Outside Directors, etc. (see the note to Subsection (2)), the period pertaining to the requirements for Outside Directors etc., be limited to 10 years. In the Subcommittee there was comment that five years or seven years was appropriate as a period for which it can be expected that as result of the relationship with the company having ended the former relationship with management had weakened sufficiently so that even persons who had once been in the management chain of command could effectively carry out the functions expected from Outside Auditors, etc., but this was not the preponderant opinion, and taking into account the background of the revision discussed in the preceding paragraph, a period of 10 years is proposed in the Interim Proposal.

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The note to Subsection (2) provides for taking the necessary measures to prevent circumvention of the rules concerning Outside Directors and Outside Company Auditors. Specifically speaking, for example, the following could be added as a requirement for Outside Company Auditors: that persons who had been Company Auditors of the Stock Company or of its Subsidiaries in the 10 year period prior to becoming an Outside Company Auditor may not have been a Director, Accounting Advisor or Executive Officer or Manager or other employee of the Stock Company or its Subsidiaries during the 10 year period prior to becoming such Outside Company Auditor; and the same requirement could be added with respect to Outside Directors (a requirement for persons who were a non-executive Director, Accounting Advisor or Company Auditor in the 10 year period prior to becoming an Outside Director may not have been an Executive Director or Executive Officer or Manager or other employee of the Stock Company or its Subsidiaries during the 10 year period prior to becoming such Director, Accounting Advisor or Company Auditor).

### **(3) Partial Exemption from Liability for Directors and Company Auditors**

Under current law, the Directors and Company Auditors who may conclude what are called agreements limiting liability are limited to Outside Directors and Outside Company Auditors respectively (Companies Act, Article 427(1)). In addition, the only Directors for whom in the calculation of the minimum amount of liability specified in Article 425(1) of the Companies Act the number by which the amount of property benefits received as consideration for the execution of their duties should be multiplied is “2” (Article 425(1)(i)(c)) are the Outside Directors.

With respect to this point, those Directors and Company Auditors meeting the requirements for Outside Directors and Outside Company Auditors under current law, who, by the adopting of Proposal A in Subsection (1) and the resulting revision of the requirements for Outside Director etc., would no longer fulfill the requirements for Outside Director or Outside Company Auditor, despite having been subject to the abovementioned rules covering agreements limiting liability, would no longer be subject to those rules. However, among such Directors, etc., there may be persons who, without executing business, could be effective in carrying out the functions of audit and supervision in terms of their knowledge, experience and incentives. From the perspective of securing and utilizing the human resources represented by such persons, even if Proposal A in Subsection (1) is adopted and the requirements for Outside Directors, etc., thus revised, Directors who under current law are subject to the rules regarding agreements limiting liability could remain subject to those rules even after such revision.

Additionally, the point was raised that the scope of Directors, etc., to whom the rules covering agreements limiting liability should apply should, fundamentally, be demarcated on the basis of whether they are involved in the execution of business rather than on whether they are Outside Directors, etc. On this point, because it cannot not necessarily be concluded that persons who do not themselves execute business and who are expected to exclusively conduct auditing and supervision over management, are in the position of being able to

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autonomously control the risk of their incurring liability, it might be considered appropriate to allow leeway for fixing the monetary amount of their liability for compensation (limiting the risk in advance) by means of an agreement limiting liability. It was also commented that even if agreements limiting liability are allowed for persons who themselves do not participate in the execution of business, the potential harm would be small from the standpoint of the prevention of dereliction of duties.

Taking the foregoing into account, in Chapter I, 3 (3) of the Interim Proposal, if Proposal A in Subsection (1) is adopted and the requirements for Outside Directors etc. are revised, Item (i) provides that Directors who are not Executive Directors, Executive Officers, or Managers or other employees (see Item (a)) and all Company Auditors (see Item (b)) may enter into agreements limiting liability, and Item (ii) provides that the minimum liability amount of the Directors falling under Item (i) (a) above shall be revised to be the same as the amount for Outside Directors as specified in Article 425(1)(1)(c) of the Companies Act.

## **II. Audit Function of Company Auditors**

### **1. Decisions on Proposals, etc., concerning the Selection and Dismissal, etc., of Accounting Auditors and their Compensation etc.**

- (1) Under current law, in Companies with Auditors, decisions on agenda items and proposals concerning the election, dismissal and non-reelection of Accounting Auditors, and decision-making authority over the compensation, etc. of Accounting Auditors are the authority of the Directors or of the Board of Directors. On the other hand, Company Auditors and the Board of Auditors have the right of consent with respect to proposals etc. concerning the election and dismissal, etc. of Accounting Auditors (Companies Act, Article 344) and, with regard to their compensation, the right of consent (Companies Act, Article 399(1), (2)). In Companies with Committees, in contrast to Companies with Auditors, decisions on proposals etc. concerning the election and dismissal, etc. of Accounting Auditors are the authority of the Audit Committee (Companies Act, Article 404(2)(ii)), but similarly with Companies with Auditors, the Audit Committee has the right of consent for decisions on the compensation etc. of Accounting Auditors (Companies Act, Article 399(3)).

With respect to these rules under current law, it was commented that a framework whereby Directors or Board of Directors, who are in the position of being subject to audit by Accounting Auditors, decide proposals etc. concerning the election and dismissal, etc. of Accounting Auditors and their compensation is problematic from the standpoint of the independence of Accounting Auditors, and therefore the authority for such decisions should instead be granted to Company Auditors or the Board of Auditors, or the Audit Committee. On this point, on June 8, 2007, when the bill for the partial revision of the Certified Public Accountants Act was passed in the Committee on Financial Affairs of the House of Representatives, a supplementary resolution was also passed stating, “Corporate governance is a precondition for ensuring the appropriateness of financial information; efforts will be directed to ensure the proper functioning of Company Auditors or Audit Committees, and in

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regards to measures for granting to Company Auditors decision-making authority on proposals for the election and dismissal of Accounting Auditors and decision-making authority on audit compensation, serious deliberations will continue, with the aim of quickly reaching a conclusion.” (On June 15, 2007 a supplementary resolution to the same effect was also passed in the Committee on Financial Affairs of the House of Councillors.)

On the other hand, it was commented in the Subcommittee that the independence of Accounting Auditors could just as well be ensured through the appropriate exercise of the abovementioned authorities held by Company Auditors, Board of Auditors or Audit Committees under current law. In particular, in light of the fact that Company Auditors are a specialized audit body separate from the body which executes business (decisions), their position is strengthened through such provisions as their term being four years (Companies Act, Article 336(1)) and the requirement that a resolution for their dismissal be a special resolution of a Shareholders Meeting (Companies Act, Article 309(2)(vii)). For these reasons it was commented that granting decision-making authority on matters concerning the execution of business to Company Auditors or Board of Auditors is also not appropriate because, if rectification of decisions of Company Auditors or Board of Auditors becomes necessary, due to the abovementioned scheme by which the position of Company Auditors is strengthened, the possibility for rectification by means of the replacement of Company Auditors is limited.

Because opinions were divided within the Subcommittee on the question of the appropriateness of granting decision-making authority to Company Auditors or Board of Auditors etc. and the scope of such decision-making authority as outlined above, three separate proposals are listed in Chapter II, 1 of the Interim Proposal — Proposals A and B, which call for revising the rules under current law, and Proposal C, which calls for making no revisions with respect to proposals etc. concerning the election and dismissal etc. of Accounting Auditors and their compensation etc.

- (2) Of the two proposals calling for the revision of the rules under current law, Proposal A provides for revising these rules by granting to Company Auditors and Board of Auditors decision-making authority with respect to proposals, etc. concerning the election and dismissal etc. of Accounting Auditors and decision-making authority over the compensation etc. of Accounting Auditors and granting to the Audit Committee decision-making authority over the compensation etc. of Accounting Auditors. This is based on the idea that from the perspective of ensuring the independence of Accounting Auditors it is necessary to grant all decision-making authority for proposals, etc. concerning the election and dismissal etc. of Accounting Auditors and the decision-making authority over their compensation etc. to Company Auditors or the Board of Auditors or the Audit Committee.

Proposal B calls for revising the rules under current law by granting to Company Auditors or the Board of Auditors decision-making authority for proposals etc. concerning the election and dismissal etc. of Accounting Auditors. (It does not call for revising the rules under current law with regard to the authority of the Audit Committee.) This is based on the idea

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that, given that the compensation etc. of Accounting Auditors is closely related to management decisions concerning the finances of a Stock Company, it is proper for these matters to be decided by the Directors or Board of Directors. If Proposal B is adopted, the decision-making authority of the Company Auditors and the Board of Auditors for proposals etc. concerning the election and dismissal etc. of Accounting Auditors and the right of consent with respect to their compensation would be the same authority that the Audit Committee now holds under current law.

## **2. Framework for Ensuring the Effectiveness of Company Auditors**

Chapter II, 2 of the Interim Proposal suggests three changes to the framework for ensuring the effectiveness of audits by Company Auditors.

- (1) First of all, with respect to the systems necessary to ensure the properness of operations of a Stock Company (internal control systems, Article 362(4) (vi), et al.), it calls for strengthening and fleshing out provisions relating to the systems which support audits. In specific terms, as it was pointed out that securing employees who act in accordance with the directives of Company Auditors and assist them in carrying out their duties and ensuring adequate funding for audits is necessary for the implementation of effective audits, adding to the items concerning internal control systems items providing for the effectiveness of the directives of Company Auditors to the employees who assist them in the performance of their duties and items concerning the company's policies with respect to audit expenses might be considered.
- (2) Next, it was additionally commented in the Subcommittee that, from the perspective of facilitating the submission by employees to Company Auditors of information concerning wrongdoing, employees should decide on proposals to be submitted to the Shareholders Meeting regarding the election of some of the Company Auditors. In response to this, comment was also made in the Subcommittee that if, hypothetically, there were inadequacies in the collection by Company Auditors of information for audits, it would be more appropriate for a Stock Company to address this by improving systems whereby Directors and employees submit information about such matters as violations of laws and regulations to Company Auditors.

Under current law, as matters concerning internal control systems, “systems for Directors and employees to make reports to Company Auditors and other systems concerning making reports to Company Auditors” (Ordinance for Enforcement of the Companies Act, Article 100(3)(iii), et al.) have been prescribed. It would be possible to clarify that such systems for making reports to Company Auditors includes a system for ensuring that any employee who makes a report will not be treated unfavorably, and in order to ensure that information on wrongdoing is more appropriately submitted to Company Auditors, explicitly stating as a matter concerning internal controls, for example, that an employee will not be treated unfavorably for having submitted to Company Auditors information on violations of laws or regulations.

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Accordingly, with respect to internal control systems, Section 2 calls for the provisions relating to systems for the collection by Company Auditors of information from employees to be made thorough and specific, and the note to the section states that further consideration is required on the matter of employees deciding on proposals for the election of Company Auditors.

- (3) Current law provides that systems for ensuring the effective implementation of audits by Company Auditors be included in the internal control systems of Companies with Auditors (Ordinance for Enforcement of the Companies Act, Article 98(4) and Article 100(3)). In addition, a summary of decisions or resolutions concerning the maintenance of internal control systems is to be included in business reports (Ordinance for Enforcement of the Companies Act, Article 118(ii)) and items concerning the appropriateness thereof are to be included in audit reports (Ordinance for Enforcement of the Companies Act, Article 129(1)(v) and Article 130(2)(ii)).

In this regard, because the point was raised that, from the perspective of the coordination between Company Auditors and internal control systems, such matters as a summary of the state of implementation of internal control systems should be included in business reports (Ordinance for Enforcement of the Companies Act, Article 118 et al.), Section 2 calls for making such revisions.

### **III. Corporate Governance in Financing Activities**

#### **1. Issue of Shares for Subscription through a Private Placement in conjunction with a Change in the Controlling Shareholder**

##### **(1) Necessity of Resolution of a Shareholders Meeting**

A. Under current law, when a Public Company undertakes for example an Issue of Shares for Subscription through a private placement, the resolution of a Shareholders Meeting is not required except when the amount to be paid is particularly favorable to the subscriber (Companies Act, Article 201(1) and Article 199(3)). With respect to this, comment was made that, from the perspective that shareholders rather than managers should decide on a change of Controlling Shareholder, this sort of rule under current law should be revised in such a way that the resolution of a Shareholders Meeting be required with respect to such matters as the Issue of Shares for Subscription through a private placement in conjunction with a change in Controlling Shareholder. On the other hand, it was also pointed out that if a resolution of a Shareholders Meeting were required for the Issue of Shares for Subscription, a flexible response might not be possible in the event of an urgent need to obtain financing, with results that, contrary to the intent of the revision, are against the best interests of shareholders.

Because various opinions were voiced in the Subcommittee on the question of whether or not to require a resolution of a Shareholders Meeting with respect to such matters as the Issue of Shares for Subscription through a private placement in conjunction with a change in control and on what sort of measures should be adopted to make it possible to

deal flexibly with a situation in which there was an urgent need to obtain financing if, hypothetically, the resolution of a Shareholders Meeting were to be required, in Chapter III, 1, (1) of the Interim Proposal three different proposals — Proposals A, B and C — were set forth. In order to enable a flexible response in the event of an urgent need to obtain financing, Proposal C does not call for a revision of the rules under current law. From similar considerations, both Proposal A and Proposal B, which do call for the revision of the rules under current law, limit the instances in which a resolution of a Shareholders Meeting is required, not requiring that there always be a resolution of a Shareholders Meeting with regard to such matters as the Issue of Shares for Subscription through a private placement in conjunction with a change in Controlling Shareholder.

Proposal A, while in principle requiring an ordinary resolution of a Shareholders Meeting with regard to the Issue of Shares for Subscription through a private placement in conjunction with a change in Controlling Shareholder, provides also that it may be stipulated in the Articles of Incorporation that a resolution of a Shareholders Meeting may be omitted if the Board of Directors finds there is a need to do so given the necessity, urgency, or other situation concerning the financing. If a Public Company intends to omit the resolution of a Shareholders Meeting pursuant to such a stipulation in its Articles of Incorporation and there is an objection, the company shall notify its shareholders or make public notice to the effect that they must raise their objections within a specified period and if shareholders holding three one-hundredths (3/100) or more of the voting rights of all shareholders raise an objection within that period the omission of a resolution of a Shareholders Meeting will not be allowed. This is modeled on the rules of Article 426 of the Companies Act concerning the partial exemption from liability of Officers by the Directors (Board of Directors). In Article 426(3) of the Companies Act it is stipulated that such period may not be shorter than one month; however, from the standpoint of giving consideration to the urgency with which the financing may be required, for example, a period of two weeks subsequent to giving notice or public notice is conceivable. The type of resolution of a Shareholders Meeting required is an ordinary resolution because a resolution concerning the Issue of Shares for Subscription through a private placement in conjunction with a change in Controlling Shareholder, in that it represents a decision about the person controlling the business of a company, has aspects in common with the election of Directors and therefore the requirements for such a resolution of a Shareholders Meeting (Companies Act, Article 309(1)) are taken as reference. Further consideration is required as to whether the same rules applying to a quorum, as in the case of the election of Directors (Companies Act, Article 341), should be established here as well.

With respect to such matters as an Issue of Shares for Subscription through a private placement in conjunction with a change in Controlling Shareholder, Proposal B calls for requiring a vote of a Shareholders Meeting if shareholders holding a specified number of voting rights make known their objection to the Issue of Shares for Subscription within a

specified period of time. Taking as a point of reference the fact that in a Reorganization which meets the requirements for a simplified reorganization, if shareholders holding a specified number of voting rights give notice of their objection, because of the possibility the proposal might be voted down if a Shareholders Meeting were held, a resolution of a Shareholders meeting is required (Companies Act, Article 796 (4)), Proposal B provides for establishing rules having the same effect. For the same reason as Proposal A, Proposal B also stipulates that the resolution of the Shareholders Meeting be an ordinary resolution; and in view of the above purport of Proposal B, it is proper to stipulate that the number of voting rights held by shareholders who have given notice of their objection must be a number sufficient to possibly prevent the passage of an ordinary resolution should a Shareholders Meeting be convened. Specifically, if there is no provision otherwise in the Articles of Incorporation with respect to the requirements for an ordinary resolution, notice of objection from shareholders holding more than one fourth (1/4) of all shareholders' voting rights would be necessary for a resolution of a Shareholders Meeting to be required. However, in order to allow for the appropriate handling of cases where there are other provisions concerning requirements for an ordinary resolution in the Articles of Incorporation, the specific method for the calculation of the number of necessary voting rights could be determined by an ordinance of the Ministry of Justice (see Article 197 of the Ordinance for Enforcement of the Companies Act). With respect to the period in which to give notice of objection, similarly to Proposal A, for example, a period of within two weeks from notice to its shareholders or public notice by a Public Company could be stipulated.

- B. If either Proposal A or Proposal B is adopted, it could be stipulated that those Issues of Shares for Subscription which could be subject to a resolution of a Shareholders Meeting because such Issue would entail a change in Controlling Shareholder be Issues whereby the subscriber will become the new Parent Company of a Public Company. Because there could be an impact on the validity of an Issue of Shares for Subscription if, despite being required, no resolution of a Shareholders Meeting was held with respect to such Issue of Shares for Subscription, it would not be proper that the scope of the Issues of Shares for Subscription requiring a resolution of a Shareholders Meeting be determined on the basis of substantial criteria such as notions of a Parent Company, and such scope should be determined on the basis of objective and formal criteria. Accordingly Chapter III, 1 (1) provides that in the case of an allotment of shares to a subscriber, an Issue of Shares for Subscription through a private placement that results in such subscriber coming to hold a majority of the voting rights of all shareholders is an Issue of Shares for Subscription that may require a resolution of a Shareholders Meeting. However, because if such subscriber is the Parent Company etc. (a Parent Company or a natural person having the same amount of influence as a Parent Company) of the Public Company prior to the Issue of Shares for Subscription, such Issue of Shares for Subscription cannot be seen as entailing a change in Controlling Shareholder and is therefore exempted from the rules. However,

the point was made in the Subcommittee that in a case where the subscriber in an Issue of Shares for Subscription through a private placement comes to hold more than one third (1/3) of the voting rights of all shareholders, because such subscriber may in actuality control the Public Company, such Issues of Shares for Subscription should also be subject to the rules such as in Proposal A or Proposal B. Accordingly, Note 1 states that further consideration is required on this point.

However, even if the rules of either Proposal A or Proposal B are put in place, if no similar rules concerning Share Options for Subscription are also put in place, the rules could easily be evaded by a subscriber immediately exercising its Share Options after an Issue of Share Options for Subscription. Therefore, further consideration seems necessary with respect to establishing some rules concerning the Issue of Share Options for Subscription. In regards to the scope of Issues of Share Options for Subscription that would be subject to such rules, given that it is permitted to stipulate not only a fixed number as the number of shares that are the target of the Share Options, but also the method for calculating such number (Companies Act, Article 236(1)(i)), further consideration is required. This is why Note 2 states that further consideration is necessary with respect to the handling of Issues of Share Options for Subscription.

## **(2) Enhanced Disclosure of Information**

Under current law, when an Issue of Shares for Subscription is made through a private placement by resolution of the board of directors, a Public Company shall provide notice to shareholders no later than two weeks prior to the payment date or to the first day of the payment period (Companies Act, Article 201(3)) of matters relating to the subscription including the number of the Shares for Subscription and the Amount To Be Paid In (Companies Act, Article 199(1)); but there are no rules established for disclosure of information concerning matters pertaining to the allotment of Subscription Shares. However, from the standpoint that a change of Controlling Shareholder is something that shareholders, not managers, should decide, regardless of whether Proposal A or Proposal B of Subsection (1) is adopted, in the event that a change of Controlling Shareholders will occur as the result of an Issue of Shares for Subscription through a private placement, there may be a need to disclose matters concerning the allotment of Shares for Subscription in order to provide shareholders with information concerning that change to assist in determining whether to exercise the right to demand cessation (Companies Act, Article 210) or (if a resolution of a Shareholders Meeting is necessary) their voting rights at a Shareholders Meeting.

Taking this into account, in a case where a Public Company is to carry out an Issue of Shares for Subscription through a private placement as in Subsection (1), Chapter III, 1 (2) of the Interim Proposal makes notice to shareholders obligatory in order to enhance the disclosure of information concerning change of Controlling Shareholder. From the standpoint that shareholders, rather than managers, should decide on change of Controlling Shareholder, information about the kind of Controlling Shareholder who will result from such Issue of Shares for Subscription is important; and therefore the following items are listed as matters

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requiring notice: 1) the name and address of the subscriber who will hold a majority of the voting rights of all shareholders as a result of the Issue of the Shares for Subscription and 2) the number of voting rights the subscriber will hold as a result of the Issue of the Shares for Subscription.

Furthermore, from the standpoint of enhancing the disclosure of information concerning change of Controlling Shareholder, in addition to the items listed above, Note 1 lists other items which might also be considered as items requiring notice. First of all Item (a) provides that the number of the voting rights pertaining to the Shares for Subscription allocated to the subscriber through the Issue of Shares for Subscription must be included in the items requiring notice as information indicating the degree of change of control through the Issue of Shares for Subscription. Additionally, Items (b) through (d) provide that the particulars of the decision of the Board of Directors with respect to the Issue of Shares for Subscription and the opinions of Outside Directors and Outside Auditors also be included in the items requiring notice. The matter of what should be the subject of those decisions and opinions is not explicitly stated, but in view of the intent of enhancing the disclosure of information concerning a change in the Controlling Shareholder as a source of reference for shareholders in making their evaluation and decision as to the appropriateness of the change of Controlling Shareholder resulting from the Issue of Shares for Subscription, what seems to be required is the disclosure of the judgments and opinions of the foregoing persons in accordance with their respective duties.

Under current law, the notice of items relating to a Subscription of Shares may be done by public notice (Companies Act, Article 201(4)), but in cases where the same items are disclosed in the securities registration statement (Financial Instruments and Exchange Act, Article 5(1)) notice to shareholders is not required (Companies Act, Article 201(5)) because there would little benefit in repeating notification pursuant to the Companies Act. Because it could be considered reasonable to establish similar rules with respect to items requiring notice with regard to an allotment of Shares for Subscription, the main text of Subsection (2) states that the notice may be made by public notice and Note 2 says that, if disclosure is made in the securities registration statement, notice to shareholders may be omitted.

## **2. Consolidation of Shares**

### **(1) Demand for Purchase of Fractional Shares**

Under current law, fractions of shares result from a Stock Company's implementation of a Consolidation of Shares are processed through the delivery of money, with the proceeds from the sale by auction of shares in a number equivalent to the aggregate of the fractional shares to be delivered to the shareholders in proportion to the fractions attributed to them (Companies Act, Articles 235 and 234). However, in a consolidation of shares, because a large number of fractional shares result, if the fractional shares are processed in this manner, there is the danger that proper consideration for the fractional shares will not be delivered due to such factors as a decline in the market price or difficulty in securing buyers.

Taking the foregoing into consideration, in order to enhance the procedures for the delivery of proper consideration to shareholders of fractional shares in a case where many fractional shares result from a Consolidation of Shares, Chapter III, 2, (1) of the Interim Proposal calls for the establishment of a system whereby, in addition to the processing of fractional shares through the delivery of proceeds under current law, shareholders may demand that the Stock Company purchase the fractional shares. However, because the establishment of this type of system could result in a financial burden from payment of the purchase price etc. and an increase in costs in terms of the time and procedures involved in the price determination, in cases where in light of the number of fractional shares resulting from the Consolidation of Shares the impact on shareholders from the fractional shares would be small, the demand for the purchase of fractional shares will not be allowed. Specifically, in Item (i), when the number resulting from multiplying the number of share units by the ratio of consolidation (Companies Act, Article 180(2)(i)) is an integer, demands for purchase of fractional shares shall not be allowed. This is because, in such a case, only shares constituting less than one voting unit will result in fractional shares, so the impact on shareholders holding shares resulting in fractional shares from the Consolidation of Shares will be small. In addition to this, typically, when the ratio of consolidation is large (in other words, when the reduced number of issued shares resulting from the Consolidation of Shares is small) there is limited likelihood of many fractional shares occurring. At the same time, however, the point was raised in the Subcommittee that even in such a case, depending on the distribution of shares, the occurrence of a large number of fractional shares could have a significant impact on the shareholders owning them; and therefore it is not proper to disallow demands for purchase of fractional shares simply on the basis that the consolidation ratio is large. Taking this into account, Note 3 in Item (i) states that further consideration is required as to whether the demand for purchase of fractional shares will be allowed if the ratio of consolidation exceeds a certain ratio, for example, one tenth (1/10).

In addition, it was pointed out in the Subcommittee that, because the interests of shareholders who did not oppose the Consolidation of Shares should also be protected, the right to demand purchase should not be limited to dissenting shareholders. However, if the demand for purchase was allowed regardless of whether the shareholder was a dissenting shareholder or not, especially in a case for example where the Consolidation of Shares is used as a means to cash-out, there is the danger of an increase in the number of shares subject to demands for purchase, leading to an increase in procedural costs; in addition, the restrictions concerning the source of funds for the acquisition of Treasury Shares would not be applicable with respect to the acquisition of Treasury Shares pursuant to a demand for purchase of fractional shares (see Item (xii)) and this could harm the interests of company creditors. Also because shareholders who feel that a proper price may not be paid in the processing of fractional shares might for that reason dissent to the Consolidation of Shares (see the note to Item (iii) regarding the enhancement of disclosure of information for materials used in making a judgment as to whether to dissent or not), careful further

consideration is required on the question of whether to allow the demand for purchase of fractional shares even to non-dissenting shareholders. Accordingly, in Item (i) the right to demand purchase of fractional shares is limited to dissenting shareholders (the definition of “dissenting shareholder” in Item (ii) takes as a point of reference the share purchase demand in a Reorganization).

The processing of fractional shares for which a demand for purchase has not been made shall be in accordance with the processing of fractional shares through the delivery of money as prescribed in Article 235 of the Companies Act (see Note 2 to Item (ii)). However, because of the risk that if some dissenting shareholders were to demand purchase of only some of their fractional shares the processing of fractional shares would become needlessly complicated, Note 1 to Item (i) states that dissenting shareholders may demand only a one-time purchase of all of the fractional shares they own.

Taking into account that Consolidations of Shares in which demands for purchase of fractional shares are allowed could have a significant impact on the interests of shareholders in such situations as when many fractional shares may arise and some shareholders thereby lose their position as shareholders, Items (iii) and (xi) call for the establishment of procedures for advance disclosure and after-the-fact disclosure similar to those in a Reorganization. The advance disclosure procedures prescribed in Item (iii) call for the disclosure of the consolidation ratio (Companies Act, Article 180(2)(i)), the day when the Consolidation of Shares will take effect (Article 180(2)(ii)) and the classes of the shares to be consolidated (Article 180(2)(iii)). Additionally, in view of the fact that as outlined above the shareholders who may demand purchase of fractional shares are limited to dissenting shareholders, it could be considered necessary to enhance the disclosure of information concerning the method etc. of the disposition of fractional shares in order to provide shareholders with the material they need to judge whether or not to dissent to the Consolidation of Shares at a Shareholders Meeting. Although the final amount of payment to be made to shareholders from the processing of fractional shares cannot be disclosed in advance because it depends on the actual proceeds from the sale of the fractional shares, it is conceivable that there could be prior agreement on such matters as the method of processing the fractional shares and the sale price of the fractional shares. Therefore matters requiring disclosure could include matters concerning the method of the processing of the fractional shares pursuant to Article 235 of the Companies Act and matters concerning the amount of money to be delivered to shareholders in the processing of fractional shares (matters concerning the prospects for the amount, matters concerning its appropriateness, etc.) (see the note to Item (iii)). In cases where a Consolidation of Shares is used as a means to cash-out, this has significance as a disclosure about the cash-out consideration to be delivered to minority shareholders. In addition, the procedures for after-the-fact disclosure called for in Item (xi) require the disclosure of matters concerning the Consolidation of Shares. Specifically, such matters as the Effective Date of the Consolidation of Shares and the status

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of the procedures for the demand for purchase of fractional shares could be matters requiring disclosure.

Items (iv) through (x) specify the procedures for handling demands for purchase of fractional shares. The rules covering such matters as notice to shareholders or public notice by a Stock Company, the period for demand for purchase of fractional shares, restrictions on the revocation of a demand for purchase, the period for discussions regarding the determination of purchase price, and petition to a court for a determination of the price are fundamentally the same as the rules established for share purchase demands in a Reorganization. With respect to when the purchase comes into effect, for share purchase demands in a Reorganization there are cases where this is the time of payment (see Article 798(5) of the Companies Act) and cases where this is the Effective Date of the Reorganization (see Article 786(5) of the Companies Act.), but from the standpoint that in the case of demands for purchase of fractional shares there needs to be flexibility, so the purchase comes into effect as of the Effective Date of the Consolidation of Shares (see Item (x)).

Item (xii) states that in regards to the Distributable Amount regulations relating to acquisition of Treasury Shares in response to a demand for purchase of shares, the regulations on the source of funds for the acquisition of Treasury Shares (Companies Act, Article 461(1)) shall not apply, as is the case under current law for other share purchase demand regimes. At the same time, because a Consolidation of Shares is something that a Stock Company can do acting on its own, it cannot be said that there is no risk of a demand for purchase of fractional shares being improperly used for the purpose of return of company assets. For that reason, taking as a model the rules concerning share purchase demands prescribed in Article 116(1) of the Companies Act, about which the same comment could be made, Item (xii) provides that if the amount of money to be paid to shareholders who made demand for purchase of fractional shares exceeds the Distributable Amount on the day of payment, the Executing Persons who performed the work duties relating to the acquisition of the shares shall bear the same liability as the liability prescribed in Article 464 of the Companies Act.

In addition to the foregoing, in regards to procedures etc. relating to demands for purchase of fractional shares, it is necessary to establish provisions covering procedure details in the manner of the system for demand for purchase of shares in a Reorganization, etc. Further, in regards to purchase accounts (see Part 2, Chapter IV, 1 of the Interim Proposal) and payment prior to price determination (see Part 2, Chapter IV, 2 of the Interim Proposal), provisions should be provided that are similar to those concerning share purchase demands in a Reorganization. Accordingly, the notes at the end of Subsection (1) state that provisions necessary with respect to procedures etc. concerning the demand for purchase of fractional shares will be established in conformity with the system for the demand for purchase of shares in a Reorganization etc.

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Because it was pointed out that if a Consolidation of Shares is made together with an Issue of Shares for Subscription through a private placement, the possibility of harm to the interests of shareholders is great, in the Interim Proposal Consolidation of Shares is treated as a matter relating to corporate governance in financing activities. If a system for demand for purchase of fractional shares is established in the first place, Consolidation of Shares could be used as a means to cash-out. In such case the system would take on the significance of a method for providing relief to minority shareholders in a cash-out (see the note to Part 2, Chapter III, 3 of the Interim Proposal.).

## **(2) Rules Concerning the Total Number of Authorized Shares**

Under current law, when shares are consolidated the number of Issued Shares decreases but the Total Number of Authorized Shares does not change. However, the point was raised that if the Total Number of Authorized Shares is allowed to exceed four times the total number of Issued Shares subsequent to a Consolidation of Shares, the intent of the Total Number of Authorized Shares system, namely, demarcating a limit to the decrease in the shareholding ratio of existing shareholders, would not be achieved. In view of the intent of the abovementioned system, it would be appropriate for the shareholders to decide the Total Number of Authorized Shares on the Effective Date of a Consolidation of Shares (i.e., the Total Number of Authorized Shares subsequent to the Consolidation of Shares) within a scope not exceeding four times the total number of Issued Shares on the Effective Date of a Consolidation of Shares.

Thus Chapter III, 2 (2) (i) of the Interim Proposal provides that the Total Number of Authorized Shares on the Effective Date shall be added to the matters that must be decided by resolution of the Shareholders Meeting when a Stock Company intends to implement a Consolidation of Shares (Companies Act, Article 180(2)). In addition, Item (ii) provides that in a Public Company the Total Number of Authorized Shares may not exceed four times the Total Number of Shares issued at the time the Consolidation of Shares comes into effect. Further, because the Total Number of Authorized Shares is a matter that must be included in the Articles of Incorporation (Companies Act, Article 37(1) and Article 98), a revision of this number requires a revision of the Articles of Incorporation. Therefore Item (iii) provides that the provision of the Articles of Incorporation regarding the Total Number of Authorized Shares shall be changed on the Effective Date in accordance with the resolution of the Shareholders Meeting of Item (i).

The Total Number of Authorized Shares on the Effective Date may be decided in whatever manner is seen fit, provided that it is within the scope of four times the total number of Issued Shares at the time the Consolidation of Shares came into effect. If the Total Number of Authorized Shares is within such a scope prior to the Consolidation of Shares, it would be possible, by stipulating the same number through resolution of the Shareholders Meeting of Item (i), to decide not to change the Total Number of Authorized Shares and in that case the provision of the Articles of Incorporation regarding the Total Number of Authorized Shares would not be revised.

### 3. Issue of Shares for Subscription based on a Faked Payment

Under current law, no provisions are provided regarding liability of subscribers or Directors etc. involved in an Issue of Shares for Subscription based on a faked payment. In the case of an Issue of Shares for Subscription based on a faked payment, regardless of how the legal validity of the Issue of Shares for Subscription may be construed under law, there is a likelihood of a transfer of value from existing shareholders to the subscriber. More specifically, under the Commercial Code prior to its revision by Law No. 87 of 2005 (hereinafter referred to as the “Old Commercial Code”), in cases where a registration of change pursuant to an issue of new shares was made despite there not having been valid payment, the Directors owed a warranty against defects in subscriptions (Article 280-13 of the Old Commercial Code) and on the basis of this, even in cases such as where payment was made with so-called “show money,” the issue of new shares itself was not construed as being invalid (Supreme Court, January 28, 1997, Third Petty Bench Decision, *Supreme Court Civil Law Reports*, Vol. 51, No. 1, p. 71). In contrast to this, under current law, the warranty against defects in subscriptions has been abolished because, among other reasons, it was thought that it would not be appropriate for a Director to subscribe to shares without going through the prescribed procedures. Therefore, although the question of the validity of an Issue of Shares for Subscription based on a faked payment itself cannot be called completely clear in legal terms, if, hypothetically, an Issue of Shares for Subscription based on a faked payment is understood to be valid, this would mean that despite the Issue of Shares for Subscription, no assets of corresponding value were contributed, and a transfer of value from existing shareholders to the subscriber would occur. Furthermore, even if the Issue of Shares for Subscription based on a faked payment was understood to be invalid, because it would be difficult to identify the invalid Shares for Subscription once they were sold in the market, in reality the same problem could arise.

It was commented in the Subcommittee that, with respect to methods for providing remedies in cases of this kind of transfer of value, seeking to hold Directors liable to the Stock Company and third parties (Article 423(1) and Article 429(1) of the Companies Act) and other methods based on rules under current law were not necessarily sufficient. There were no differing opinions on this point.

Accordingly, Chapter III, 3 of the Interim Proposal calls for a revision of the liability of subscribers and Directors etc. who participate in faking payments pertaining to the Issue of Shares for Subscription.

Item (i) addresses the liability of subscribers. Under current law, when a subscriber to Shares for Subscription does not make a contribution, the subscriber forfeits the right to become the shareholder of the Shares for Subscription by making that contribution (Article 208(5) of the Companies Act). Taking into account the precedent (see Supreme Court, December 6, 1963 Second Petty Bench Decision, *Supreme Court Civil Law Reports*, Vol. 17, No. 12, p. 1633) that a payment by so-called show money is not valid as a payment, it would seem that a subscriber who has made a faked payment has forfeited the right to become the shareholder of the Shares

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for Subscription by failing to make a contribution and, once the payment date has passed or the period for payment has elapsed, has been released from the duty to make payment. However, because a subscriber who made a faked payment has, as outlined above, benefitted from the transfer of value from existing shareholders, it is reasonable to require that that value be returned. Accordingly, in Item (i), with respect to cases of an Issue of Shares for Subscription based on a faked payment, the above rules are revised and the subscriber to the Shares for Subscription owes the duty for payment even after the payment date has passed or the payment period has elapsed. Furthermore, there is the danger that because the Directors etc. of the Stock Company and the subscriber making the faked payment have an understanding, the Directors etc. may neglect to seek to hold the subscriber liable. For that reason, the note to Item (i) states that such duty, in the same manner as the liability of subscribers to Shares for Subscription under Article 212(1) of the Companies Act, shall be subject to an Action for Pursuing Liability, etc., as set forth in Article 847(1) of the Companies Act.

Item (ii) addresses the liability of a Director or Executive Officer (hereinafter in this Section 3 referred to as “Director etc.”) involved in a faked payment. Directors etc. who participated in faked payments can be said to be in the position to be liable for the Issue of Shares for Subscription based on a faked payment. The opinion was also voiced that because there are cases where it is difficult to obtain discharge of liability from a person who has made a faked payment, and additionally, from the standpoint of deterring faked payments, it is necessary to make Directors etc. bear liability for participating in faked payments. Accordingly, Item (ii) states that Directors etc. who participated directly or indirectly in faking payment shall owe the duty to pay to the Stock Company an amount equivalent to the faked payment. As discussed above, because, among other reasons, it was thought that it was improper for a Director to subscribe to shares without going through the prescribed procedures, the warranty against defects in subscriptions of Directors under the Old Commercial Code was abolished with the enactment of the Companies Act; however, the duty of Item (ii) differs from such a warranty against defects in subscriptions in that it imposes the duty to pay an amount equivalent to the faked payment as a special statutory liability attributable to the participation in the faked payment. In view of the nature of the statutory liability based on the abovementioned attribution, it is provided that if the Director, etc., proves that he/she did not fail to exercise care in the performance of the relevant duties, he/she can avoid this duty. However, Directors etc. who have made faked payments, in view of the character of the act, bear absolute liability. It should be noted that the duty of Item (ii) will be subject to an Action for Pursuing Liability, etc., as in set forth in Article 847(1) of the Companies Act.

With respect to Shares Solicited at Incorporation, the Companies Act abolished the warranty against defects in subscriptions of Incorporators and Directors at the time of incorporation provided under the Old Commercial Code (see Article 192 of the Old Commercial Code.); and because it is provided that if a subscriber to Shares Solicited at Incorporation fails to make payment the subscriber will forfeit the right to become the shareholder of the Shares Solicited at Incorporation by making such payment (Companies Act, Article 63(3)), if such payment is fake

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the same situation arises in the case of a faked payment pertaining to an Issue of Shares for Subscription. For that reason the note to Section 3 states that the same rules as set forth in Items (i) and (ii) above shall be established with respect to cases where a payment pertaining to the issue of shares at time of company establishment was faked.

#### **4. Notice of Allotment Concerning an Allotment of Share Options without Contribution**

Under current law, when a Stock Company makes an Allotment of Share Options without Contribution it shall give notice (allotment notice) to the shareholders and Registered Pledges of Shares indicating the particulars and the number of the Share Options allotted to the relevant shareholder, by two weeks prior to the first day of the exercise period for the Share Options (Companies Act, Article 279(2)). With respect to this point, it has been pointed out recently that the allotment notice requirements should be reviewed so as to shorten the period required for completing financing that utilizes an Allotment of Share Options without Contribution (a so-called “rights offering”).

It has been explained that the intent under current law in making the deadline for the allotment notice two weeks prior to the first day of the exercise period for the Share Options is to provide sufficient time to the shareholders who have received the Allotment of Share Options without Contribution to make preparations for the exercise of Share Options. However, it is possible that such intent could be achieved just as well if the allotment notice is made by two weeks prior to the last day of the exercise period.

On the other hand, given that notice is needed not only for shareholders but also for Registered Pledges of Shares, because changes in the rights of shareholders occur as a result of an Allotment of Share Options without Contribution, allotment notices for Allotments of Share Options without Contribution also have the function of notifying shareholders and Registered Pledges of Shares of the details of such changes. In order to fulfill this function, allotment notices should be made without delay from the date an Allotment of Share Options without Contribution comes into effect (see Article 187(2) of the Companies Act with respect to the allotment notice for Allotment of Shares without Contribution).

Thus, Chapter III, 4 of the Interim Proposal calls for revising the deadline for an allotment notice in an Allotment of Shares without Contribution from the current “two weeks prior to the first day of the exercise period for the Share Options”, to “without delay after the day on which the Allotment of Shares without Contribution takes effect and no later than two weeks prior to the last day of the exercise period for the Share Options”. If the rules are revised in this way, it thus becomes possible to start the exercise period for the Share Options without regard to notice timing, and the period needed for a rights offering can be shortened.

## **Part 2 Rules concerning Parent and Subsidiary Companies**

### **I. Protection of Parent Company Shareholders**

## **1. Multiple Derivative (Representative) Action**

### **(1) Establishment of a System of Multiple Derivative (Representative) Actions**

Taking into account the development of management through corporate groups and from the standpoint of protecting the shareholders of Parent Companies in corporate groups, Chapter I, 1 addresses the question of establishing a system allowing a shareholder of the Parent Company to file an action (multiple derivative (representative) action) for holding the Directors, etc. (Incorporators, Directors at Incorporation, Auditors at Incorporation, Directors, Accounting Advisors, Company Auditors, Executive Officers, Accounting Auditors, or Liquidators; hereinafter the same in this Section 1) of the Subsidiary liable.

The system of multiple derivative (representative) actions has been actively debated, particularly since the removal of the prohibition on holding companies in the 1997 revision of the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade.

When Directors etc. are liable to a Stock Company, due to the close relationships among Directors etc. and the feelings of camaraderie among them, it cannot be expected that the Stock Company will pursue the liability of those Directors etc. and therefore there is the risk of the interests of the Stock Company and by extension those of its shareholders being damaged, the system of derivative action under current law is seen as a means for allowing shareholders to file a representative action to hold liable the Directors etc. of the Stock Company and thereby seek to recover the interests of the Stock Company and by extension those of its shareholders. It was also commented that the intent of the system for liability of Directors etc. lies not only in this function for recovering damages but also in the function of deterrence of dereliction of duties on the part of Directors, etc. (dereliction of duties deterrent function).

Accordingly, it could be considered beneficial to examine the merits of establishing a system of multiple derivative (representative) actions from the perspective of the effectiveness of both the function for recovering damages and the function of deterrence of dereliction of duties.

It was pointed out in this regard that due to the personal relationships in a corporate group among the Directors etc. of a Parent Company and the Directors etc. of its Subsidiaries, there is a typical and structural risk that the Parent Company, which is the shareholder of the Subsidiary, will fail to hold liable the Directors etc. of the Subsidiary; and even in the case of the Directors etc. of a Subsidiary being liable to that Subsidiary, not only the Subsidiary, but the Parent Company as well, may not pursue that liability and therefore the possibility exists that compensation would not be made for damage to the Subsidiary, and consequently, that no compensation would be made for damage to the Parent Company either. It was also commented that in this kind of situation there is also the likelihood of not being able to adequately deter dereliction of duties on the part of Directors etc. of a Subsidiary. Seen from this perspective, the establishment of a system of multiple derivative (representative) actions for the protection of Parent Company shareholders might be considered.

At the same time, it was also pointed out that in cases where the Directors etc. of a Subsidiary are liable to that Subsidiary it would just as well be possible for shareholders of a Parent Company to seek compensation for damage to the Parent Company by pursuing the liability of

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the Parent Company's Directors etc. on the basis of their failure to properly administer and supervise the Subsidiary. From this perspective, it could be said that dereliction of duty on the part of the Directors etc. of a Parent Company can be deterred through their exposure to the risk of a derivative action and thus dereliction of duties on the part of the Directors etc. of Subsidiaries can be indirectly deterred.

However, in answer to this, it was commented that it is more difficult for the shareholders of the Parent Company to make clear the details of the liability of the Directors etc. of the Parent Company with regard to their administration and supervision of the Subsidiary and then prove both damage and a causal relationship than it is to pursue the liability of the Subsidiary's Directors, etc. For that reason it could be concluded that under current law, which does not allow for a system of multiple derivative (representative) actions, instances may arise in which damage to a Parent Company is not compensated and deterring dereliction of duties by Directors etc. of the Subsidiary by means of derivative action is not adequately accomplished.

Apart from the above, on the one hand the point was also raised that if it is decided to establish a system for multiple derivative (representative) actions, it would carry the risk of impacting the choice of business organization and causing an impediment to efficient management within corporate groups; while on the other hand the opinion was voiced that under current law, in which such a system does not exist, there is a likelihood that the choice of business organization has already been distorted through the exploitation of the form of subsidiaries.

Because opinion in the Subcommittee was divided with respect to the establishment of a system of multiple derivative (representative) actions, with comments from members taking the positions of agreement and opposition respectively as outlined above, Section 1 lists both Proposal A, which calls for the establishment of such a system, and Proposal B, which does not.

## **(2) Proposal A**

The basic thinking behind Proposal A, which calls for the establishment of a system for multiple derivative (representative) actions, is that a shareholder of an "Ultimate Wholly Owing Parent Company" shall be able to file a derivative action against the Directors etc. of an important Subsidiary (in the Interim Proposal, an important Subsidiary is a Subsidiary where the book value of the shares of that Subsidiary held directly or indirectly by the Parent Company represents more than one fifth (1/5) of the total assets of the Parent Company (see Item (iv))). In other words, standing as plaintiff under current derivative actions with respect to this type of Subsidiary would be permitted to the shareholders of the Stock Company's "Ultimate Wholly Owing Parent Company" and the shareholders of a Subsidiary who may file a derivative action under current law would, alongside such shareholders of the "Ultimate Wholly Owing Parent Company," continue to have standing as plaintiff in a derivative action against the Directors etc. of the Subsidiary. In the Interim Proposal, "a Shareholder of the Parent Company (limited to Stock Companies) of a Stock Company" can file a multiple derivative (representative) action (see Item (i)); the term "Stock Company" in this context means a Stock Company established pursuant to the Companies Act of Japan. In other words, for the purposes of the multiple

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derivative (representative) action system set forth in the Interim Proposal, it is assumed that the Parent and Subsidiary Company are both Stock Companies established pursuant to the Companies Act of Japan.

The specifics of Proposal A will be explained.

A. In Proposal A, the scope of Subsidiaries with respect to which a multiple derivative (representative) action would be permitted is limited to wholly owned Subsidiaries that have a certain level of materiality within a corporate group. The limitation to wholly owned Subsidiaries can be understood to relate to the scope of Parent Companies which can be plaintiffs in a multiple derivative (representative) action (limiting the persons allowed standing as plaintiff to shareholders of the “Ultimate Wholly Owing Parent Company”) and the limitation to Subsidiaries having a certain level of materiality within the corporate group can be understood to relate to the scope of the Directors etc. who can become the defendants in a multiple derivative (representative) action (standing as defendant).

(a) In both Items (i) and (ii) of Proposal A, on the day on which the shareholders of the Parent Company (limited to Stock Companies) demand of the Subsidiary that it file an action (“Demand for Initiation of an Action”) the Parent Company must be the Wholly Owing Parent Company of the Subsidiary and, moreover, must not itself have a Wholly Owing Parent Company that is a Stock Company, in other words, must be the “Ultimate Wholly Owing Parent Company” of the Subsidiary; only a shareholder of an “Ultimate Wholly Owing Parent Company” shall be able to file a multiple derivative (representative) action. It was pointed out that if the Subsidiary had minority shareholders, the pursuit of the liability of the Directors etc. of the Subsidiary could be left to them, and therefore multiple derivative (representative) actions should be allowed only in the case of a Subsidiary and a Wholly Owing Parent Company, and for that reason the foregoing restriction was made. The reason for the restriction to shareholders of the “Ultimate Wholly Owing Parent Company” is to clarify that in cases where there are multiple layers of Parent Companies, standing as plaintiff is allowed only to shareholders of the highest level Wholly Owing Parent Company that is a Stock Company. If, for example, a General Incorporated Association is the Wholly Owing Parent Company of the “Ultimate Wholly Owing Company,” such General Incorporated Association would have standing as plaintiff in a multiple derivative (representative) action as the “Ultimate Wholly Owing Parent Company” and the members of that General Incorporated Association would not have standing as plaintiff.

Furthermore, Item (i) provides that in addition to the case prescribed in the proviso to Article 847(1) of the Companies Act (see Item a.), in a case where the Parent Company suffers no damage from the facts that constitute the cause of action in a lawsuit against Directors etc. (see Item b.), a shareholder of the Parent Company may not make a Demand for Initiation of an Action. The reason for this is that, in a case where, for example, the Parent Company has obtained a gain from the Subsidiary or had a gain transferred from

the Subsidiary, in other words, a case where even though the Subsidiary may have incurred damages, the Parent Company incurred none, because the Shareholders of the Parent Company have no interest in pursuing the liability of the Directors etc. of the Subsidiary, there is no need to allow shareholders of the Parent Company to file an action relating to the damages of the Subsidiary.

Additionally, also in relation to standing as plaintiff, in order to deter frivolous actions, Item (iii) provides that, similarly to the rules under current law pertaining to derivative actions, when the Parent Company is a Public Company, only shareholders of that Parent Company who have held shares of that Parent Company continuously for the preceding six months may make a Demand for Initiation of an Action.

Comment was also made in the Subcommittee with respect to standing as plaintiff that because the relationship between a Stock Company and the shareholders of its Parent Company is an indirect one by way of the Parent Company, the right to file a multiple derivative (representative) action should be a minority shareholders right. On this point, the current derivative action system has no requirement on the number of shares that a shareholder must own and that even a shareholder holding a single share can file a derivative action, and because there is need to consider consistency with this provision, Note (a) to Item (iii) states that further consideration is required.

Further, it was pointed out in the Subcommittee that it is necessary to provide for deterrence to the filing of frivolous multiple derivative (representative) actions, and in consideration of this, Note (b) to Item (iii) indicates that further consideration is being given to prescribing that a multiple derivative (representative) action that clearly would not be in the common interest of the shareholders of the Subsidiary would be a case where shareholders of the Parent Company may not make a Demand for Initiation of an Action. With respect to this, at the time of the enactment of the Companies Act in 2005, Article 847(1)(ii) of the Companies Act bill submitted by the Cabinet listed as a case in which a Demand for Initiation of an Action could not be made “a case where it could be foreseen with reasonable certainty that the legitimate interests of the Stock Company would be significantly damaged by an action pursuing liability, etc., a case where the Stock Company would have to bear excessive expense or a case where other circumstances similar to the foregoing might occur,” but because the point was raised that due to the wording being vague there was a risk of derivative actions being unfairly restricted, it was eliminated in the revision in the House of Representatives; in view of this, further consideration is required.

In regards to the counterparty for the Demand for an Initiation of an Action, Item (i) names the Stock Company, in other words, the wholly owned Subsidiary, as is the case under current rules. The reason for this is, given that the intent of the Demand for an Initiation of an Action is to give the Stock Company, which is the holder of the right to claim compensation for damages against the Directors etc., the opportunity to decide whether or not to initiate an action, in a multiple derivative (representative) action, too, the

holder of the right to make claim should be the wholly owned Subsidiary. The wholly owned Subsidiary as the counterparty to a Demand for Initiation of an Action need not be a wholly owned Subsidiary of which the Parent Company directly owns all issued shares, but may also be one in which the shares are held indirectly, in other words, a wholly owned Subsidiary which the Parent Company indirectly controls through a multi-layered structure. Further, the intermediate wholly owned Subsidiaries in a case of the Parent Company indirectly exercising control through a multi-layered structure are not limited to Stock Companies (see the note to Item (ii)).

- (b) Next, Item (iv) provides that only the liability of the Directors etc. of a material Subsidiary can be subject to multiple derivative (representative) action. It was pointed out that to make the Directors etc. of a Subsidiary subject to the pursuit of liability by shareholders of the Parent Company, even in cases where they are in substance no more than employees who serve as heads of business units of the Parent Company, would not be consistent with the current derivative action system, which focuses on the possibility that Officers will fail to initiate legal action against other Officers; in consideration of this comment, pursuit of liability by the shareholders of the Parent Company is limited to the liability of the Directors etc. of a material Subsidiary only, who are equivalent to the Directors etc. of the Parent Company.

Because it is necessary to consider the clarity of criteria for materiality, Item (iv), modeled on the rules for a so-called simplified Assignment of Business and simplified reorganization (Companies Act, Article 467(1)(ii)(parenthetical portion) and Article 784(3) et al.), provides that the book value of the shares of the Stock Company held by the Parent Company must exceed one fifth (1/5) of the amount of the total assets of the Parent Company as of the date on which the facts constituting the cause for the liability occurred. However there remains room for further discussion, taking into account the actual circumstances of the relationship between a Parent Company and its Subsidiary, whether this standard of one fifth (1/5) is too little or too much as a criterion for establishing the scope of Subsidiaries which should be subject to a multiple derivative (representative) action.

In regards to this point, the note 1 to Item (iv) states that further consideration is required of whether it should be necessary, in order to be able to say that there is the possibility of the same level of dereliction of duty in initiating legal action on the part of the Directors etc. of the Subsidiary as on the part of the Directors etc. of the Parent Company, that as of the date on which the facts occurred which constitute the cause for the liability of the Directors etc. of the Subsidiary, the Subsidiary not only be a material one as described above, but must also be a wholly owned Subsidiary. In addition, if in determining whether the abovementioned one fifth (1/5) requirement is met, the book value of Subsidiaries which the Parent Company holds indirectly through other Subsidiaries (intermediate Subsidiaries) is to be included in the numerator, further consideration would be required regarding the method of calculation of the book value

of the shares of the Subsidiaries held indirectly by these intermediate Subsidiaries (for example, a method of multiplying the book value of the shares in the Subsidiaries on the books of the intermediate Subsidiaries by the stake of the Parent Company in the intermediate Subsidiary).

- B. In addition to the above, in regards to the specific design of a multiple derivative (representative) action system in Proposal A, Item (v) provides, similarly to the rules under current law pertaining to derivative actions, that if the Subsidiary does not file the action to hold liable its Directors etc. within 60 days from the date of the Demand for Initiation of an Action, the shareholder of the Ultimate Wholly Owing Parent Company who made the Demand for Initiation of an Action may file the action on behalf of the Subsidiary; however, similarly to the rules under current law pertaining to derivative actions (Companies Act, Article 847(5)), in cases where the Subsidiary is likely to suffer irreparable harm through the elapse of such period, the shareholder of the Ultimate Wholly Owing Parent Company of the Subsidiary may immediately file the action of Item (i) on behalf of the Subsidiary.

Item (vi) provides that if the Subsidiary has an Ultimate Wholly Owing Parent Company, Directors etc. of the Subsidiary may not be released from liability (limited liability meeting the requirements in Item (iv)) without the consent of all of the shareholders of the Ultimate Wholly Owing Parent Company in addition to the consent of all of the shareholders of the Subsidiary itself. The rationale for this is that if a multiple derivative (representative) action system is established and it were still possible to release the Directors etc. of the Subsidiary from liability with the consent of all the shareholders of the Subsidiary, as is the case under the current law (Companies Act, Article 424), the significance of establishing a multiple derivative (representative) action system would be diminished. The note to Item (vi) provides that necessary provisions will also be established with the same purport as above for rules concerning the partial release of Directors etc. from liability (see Companies Act, Article 425, et al.).

In relation to newly recognizing that the shareholders of the Ultimate Wholly Owing Parent Company have standing as plaintiffs in a derivative action, as outlined above, Note 1 to Proposal A provides that if Proposal A is adopted in actions pursuing the liability of Directors etc. of a material Subsidiary who are the target of a multiple derivative (representative) action, in order to prevent collusive lawsuits, the shareholders of the Ultimate Wholly Owing Parent Company of the Subsidiary may also intervene in the litigation as a coparty or for the purpose of assisting one side (see Article 849 of the Companies Act). Additionally, to ensure the opportunity for that intervention, Items (a) through (c) of Note 1 to Proposal A set forth taking as the point of reference Article 849 of the Companies Act a framework for notice of the suit to the subject Subsidiary (see Item (a)) from the shareholder of the Ultimate Wholly Owing Parent Company who filed the multiple derivative (representative) action, notice to the Ultimate Wholly Owing Parent Company from the Subsidiary which received the abovementioned

(Reference Translation)

notice or autonomously filed an action pursuing the liability (limited liability meeting the requirements in Item (iv)) of its Directors etc. (see Item (b)) and for notice to its shareholders or public notice by the Ultimate Wholly Owing Parent Company which received the preceding notice (see Item (c)). Furthermore, as is the case with rules relating to derivative actions under current law (Companies Act, Article 849), the Subsidiary or its shareholders may participate (intervention as coparty or assisting participation) in the multiple derivative (representative) action or other action pursuing the liability of the Directors etc. meeting the requirements of Item (iv) filed by a shareholder of the Ultimate Wholly Owing Parent Company.

In addition to the above, Note 2 to Proposal A indicates that the requisite provisions corresponding to the rules (see in particular Companies Act, Article 847(4) et al.) concerning derivative actions be established with respect to a notice of reasons for not filing an action as well.

As already discussed, the system of multiple derivative (representative) action in Proposal A is strictly for granting the shareholders of the Ultimate Wholly Owing Parent Company standing as plaintiff in a derivative action. For that reason, for example, in cases where the Ultimate Wholly Owing Parent Company controls a wholly owned Subsidiary (“Company S”) indirectly through a multi-layered structure, that Ultimate Wholly Owing Parent Company and other, intermediate wholly owned Subsidiaries would not receive a Demand for Initiation of an Action from the shareholders of the Ultimate Wholly Owing Parent Company, nor could they file a multiple derivative (representative) action (as outlined in the text of Subsection (2) above, even if a multiple derivative (representative) action system were established, if a separate intermediate wholly owned Subsidiary was a shareholder of Company S, it could file a derivative action under current law); also, only shareholders of Company S could intervene in a multiple derivative (representative) action. The reason for this is, on the assumption that the relationship is one between Wholly Owing Parent Company and Wholly Owned Subsidiaries, because the Ultimate Wholly Owing Parent Company and other intermediate Wholly Owned Subsidiaries can in reality participate in the multiple derivative (representative) action through their control of Company S, it is not essential to allow their direct participation, and furthermore, it is thought inappropriate to make the multiple derivative (representative) action system excessively complicated by allowing the direct participation of these persons.

### **(3) Proposal B and its Note**

On the basis of the criticisms raised in Subsection (1) above regarding the establishment of a system of multiple derivative (representative) actions, Proposal B calls for not establishing that system.

However, in the Subcommittee the point was emphasized that a system of multiple derivative (representative) actions is strictly a means for the protection of Parent Company

shareholders and that even if hypothetically Proposal B was adopted and a system of multiple derivative (representative) actions not established, that should not be forthwith interpreted as meaning that from the perspective of the protection of Parent Company shareholders no revision whatsoever was needed to the rules concerning Parent Companies and Subsidiaries. Therefore, in consideration of that point, the Note to Proposal B gives several specific examples of possible revisions to the rules concerning Parent Companies and Subsidiaries from the perspective of the protection of Parent Company shareholders and states that further consideration of such revisions is required. Each specific example, including the necessity of such revisions, will be further considered in the Subcommittee.

Among the specific examples cited, first of all, in regards to Item (a) of the Note to Proposal B, although it was commented in Subsection (1) above that in the event a Subsidiary has incurred damages as the result of the dereliction of duty etc. on the part of the Directors etc. of that Subsidiary, it would be sufficient to pursue the liability of the Directors of the Parent Company with respect to their administration and supervision of the Subsidiary and therefore the establishment of a system of multiple (representative) derivative action was not necessary, it was also pointed out in this regard that it cannot be said definitively that current law is clear as to whether the Directors of a Parent Company generally bear liability for the administration and supervision of a Subsidiary or its Directors. For that reason Item (a) of the Note to Proposal B, taking as reference Article 363(2)(ii) et al. of the Companies Act, which provides that a duty of a Board of Directors is to supervise the execution of the duties by Directors, cites, as an example, establishing express provisions to the effect that as its duty the Board of Directors shall supervise the execution of duties by the Directors of the Subsidiary of a Stock Company. However, even in the event that such express provisions are established, the manner of the supervision of Subsidiaries may vary considerably from corporate group to corporate group; accordingly, a certain degree of discretion to the Board of Directors of the Parent Company would be allowed. An example of the definition of the duty of supervision to be required might be the duty to adopt measures necessary to rectify any wrongful or unlawful acts, etc., on the part of Directors of the Subsidiary discovered through internal control systems, etc.

Next, Item (b) of the Note to Proposal B can be said to address the situation where damage is incurred by a Subsidiary as the result of facts that constitute a cause of liability of the Directors etc. of that Subsidiary, and as a result, the Parent Company also incurs damage, as in a decline in the value of the shares in that Subsidiary owned by the Parent Company, but if the Parent Company takes the necessary measures to pursue the liability of the Directors etc. of that Subsidiary, the damage incurred by the Subsidiary could be recovered and, as a result, the damage incurred by the Parent Company could also be recovered. Item (b) to the Note to Proposal B gives an example how the burden of proof for shareholders of a Parent Company pursuing the liability of the Directors of that Parent Company might be lightened by establishing a presumption of dereliction of duty on the part of the Directors of the Parent

(Reference Translation)

Company where despite a situation such as the foregoing, the Parent Company still does not take the necessary measures to pursue the liability of the Directors etc. of the Subsidiary.

Items (c) and (d) to the Note to Proposal B offer specific examples of new rules devised from the perspective of enhancing the collection of information pertinent to shareholders of a Parent Company for pursuing the liability of the Directors etc. of that Parent Company. Item (c) to the Note to Proposal B provides for allowing in certain cases the shareholders of a Parent Company the right to demand notice of how the company is addressing the aforementioned liability and the reasons therefor. Item (d) to the Note to Proposal B, taking as its point of reference Article 358 of the Companies Act which stipulates the right to petition for the appointment of an inspector with the court in order to have the inspector investigate the status of the operations of a Stock Company, provides for allowing the shareholders the right to petition the courts for the appointment of an inspector to investigate the condition of the business operation and the assets of a Subsidiary.

The point was raised in the Subcommittee that in relation to the protection of Parent Company shareholders, from the perspective of enhanced disclosure of information not only should the particulars of the systems (internal control systems) necessary for ensuring the properness of a Stock Company's business operations be disclosed (in regard to the rules pertaining to Parent Company and Subsidiary, the content of Article 100(1)(v), et al., of the Ordinance for Enforcement of the Companies Act, "Systems for Ensuring the Properness of Business Operations in a Corporate Group"), but also the status of the implementation of those systems should be added to the content of the business report. In this regard, as set forth in Part 1, Chapter II, 2 of the Interim Proposal, an overview of the status of the implementation of internal control systems shall be added to the content of the business report and as a result, as an overview of the status of implementation of the "Systems for Ensuring the Properness of Business Operations in a Corporate Group," for example, the status of reporting to the Parent Company from the Subsidiary would be disclosed.

#### **(4) Endnote to Section 1**

Under current law, even in cases where, subsequent to the filing of a derivative action, a Stock Company has become the Wholly Owned Subsidiary of another Stock Company as the result of a Share Exchange or the like, the shareholders who are the plaintiffs and have acquired shares of the Wholly Owing Parent Company as payment in that Share Exchange etc. may continue to pursue that action (Companies Act, Article 851)). However, the point was raised that — given that it could be viewed that even where a Share Exchange or Share Transfer is effected prior to a shareholder of a Stock Company filing a derivative action, such shareholder has not forfeited his/her position as shareholder by his/her own will and that even subsequent to the Share Exchange etc. the shareholder still has an interest in pursuing the liability of Directors etc. as a shareholder of the Wholly Owing Parent Company — when the facts constituting the grounds for such liability occurred before that Share Exchange etc., denying the right to file an action subsequent to the Share Exchange would not be appropriate.

(Reference Translation)

For that reason the endnote to Section 1 states that further consideration is required of whether shareholders of a Stock Company who as a result of a Share Exchange or Share Transfer of that Stock Company have acquired shares in the Wholly Owning Parent Company of that Stock Company may file this type of action.

## **2. Assignment by a Parent Company of Shares, etc., of a Subsidiary**

(1) Under current law there is no express provision that a Parent Company must obtain approval by a Shareholders Meeting when it wishes to assign a certain number of a Subsidiary's shares.

In a case where a Parent Company loses control over the business of a Subsidiary, which it had exercised through ownership of shares in the Subsidiary, as a result of the assignment of those shares, the effect on the Parent Company is substantially no different from a Business Transfer. Specifically, one example would be when a Parent Company assigns all or some of its shares in a Subsidiary, which thereby ceases to be a Subsidiary of such Parent Company. For that reason it is proper that the approval of the shareholders of the Parent Company be required for this kind of assignment of shares of a Subsidiary. However, because there could be an impact on the validity of an assignment if, despite approval being required, the Parent Company does not obtain approval of a Shareholders Meeting for assignment of the shares of a Subsidiary, whether a Parent Company has lost control over the business of a Subsidiary is a matter that must be determined by objective and formal criteria.

The point was also raised in the Subcommittee that if whenever a Parent Company intended to assign shares of a Subsidiary it needed to obtain approval by a Shareholders Meeting, there would be the risk that, depending on the scope of assignment made subject to such approval, the benefits of quick decision-making in a corporate group could be diminished. In this regard, there may be instances, such as a partial assignment, where despite being an assignment of shares of a Subsidiary, the overall book value of those assigned shares is small. If the approval of a Shareholders Meeting of the Parent Company were required for even that kind of assignment there is the risk that the benefits of quick decision-making in a corporate group could be diminished. For that reason, taking as a point of reference the rules covering the assignment of a significant part of a business under current law (Companies Act, Article 467(1)(ii)(parenthetical section)), it is possible to determine the necessity of approval by a Shareholders Meeting of the Parent Company by focusing on the book value of the shares of the Subsidiary to be assigned.

Taking into account the foregoing, Chapter I, 2 of the Interim Proposal states that if a Stock Company assigns all or some of the shares of a Subsidiary and the assignment does not fall under one of Item (i) or (ii) below, the Stock Company must obtain approval for the assignment agreement by a special resolution of a Shareholders Meeting prior to the day before the day the assignment becomes effective (hereinafter in this Section 2, the "Effective Date").

(Reference Translation)

- i. The book value of the shares to be assigned does not exceed one fifth (1/5) of the amount of the total assets of the Stock Company.
- ii. On the Effective Date the Stock Company will hold the majority of the voting rights of all shareholders of the Stock Company that issued the assigned shares.

The phrase “on the effective date” is used in Item (ii) above; the intent of this is that the above judgment be based on the number of voting rights held subsequent to the assignment of the shares.

In addition, for situations where assignment of shares of the Subsidiary does not fall under either Item (i) or (ii) above, Note 1 provides for rules in conformity with current rules for Dissenting Shareholders to make demand for purchase of shares in an Assignment of Business (Companies Act, Articles 469 and 470) and for simplified Assignment of Business (Companies Act, Article 468(1)).

Additionally, because “Companies etc.” other than Stock Companies (Ordinance for Enforcement of the Companies Act, Article 2(3)(ii)) may be a “Subsidiary” (Ordinance for Enforcement of the Companies Act, Article 3(1)), Note 2 provides for establishing rules equivalent to the foregoing for cases where a Parent Company assigns all or some of the shares of a Subsidiary and the Subsidiary is a company other than a Stock Company.

The above revision calls for new rules governing instances where indirect control over the business of a Subsidiary exercised through share ownership is lost as the result of an assignment of those shares; and, for example, the assignment of a business relating to the administration of a Subsidiary and not covered by the foregoing rules might separately be covered by current rules covering an Assignment of Business.

- (2) In connection with participation by Parent Company shareholders in decision-making concerning a Subsidiary, there was debate in the Subcommittee about whether, from the standpoint of the protection of Parent Company shareholders, approval by a Shareholders’ Meeting of the Parent Company should be needed for certain decisions, such as a Subsidiary carrying out a Reorganization or an Issue of Shares for subscription through a private placement.

In this regard the point was raised that if there were problems with the exercise of voting rights by the Parent Company in the Shareholders Meetings of its Subsidiary, the shareholders of the Parent Company could pursue the liability of the Directors of the Parent Company; if, going further, the approval of a Shareholders Meeting of the Parent Company was required for significant decisions of the Subsidiary, this could impair the rapidity of decision-making in the Subsidiary and detract from the maneuverability of management. Furthermore on this point, considering that requiring approval by a Shareholders Meeting of a Parent Company for certain decisions of a Subsidiary would constitute the participation of the shareholders of the Parent Company in the decision-making of the Subsidiary, which is a different juridical person from the Parent Company, careful consideration is required before establishing such rules as above.

## **II. Protection of Subsidiary Minority Shareholders**

### **1. Liability of Parent Companies, etc.**

#### **(1) The Debate within the Subcommittee**

In the discussion about the relationship between a Parent Company and Subsidiary, the comment was made that given its influence on a Subsidiary through its voting rights at Shareholders Meetings there is the risk of a Parent Company pursuing its own interests at the sacrifice of those of the Subsidiary. The point was made in the Subcommittee that, especially in the case of a transaction between a Parent Company and Subsidiary in which their interests conflict, because typically there would be a risk that the Subsidiary would suffer a disadvantage, from the standpoint of enhancing the statutory rules to protect Subsidiary minority shareholders and ensuring reasonable incentive to invest in the Subsidiary, express rules should be established with respect to the liability of a Parent Company in cases where a Subsidiary suffers a disadvantage as a result of such a transaction. On the other hand, the following points were raised in opposition to the establishment of express rules: (i) Already under current law, in addition to being possible to pursue liability against a Subsidiary Director for breach of the due care of a prudent manager and of the duty of loyalty (Companies Act, 423), according to interpretations of the duty to return a grant of property benefits received in connection with the exercise of shareholders' rights (Companies Act, Article 120(3)) and of liability etc. for tortious acts of infringement of claims through complicity in a breach of duty by a Director of a Subsidiary (Civil Code, Article 709), the pursuit of liability against the Parent Company is allowed and the protection of Subsidiary minority shareholders can be sufficiently achieved; and (ii) relationships between Parent Companies and Subsidiaries vary from company to company and to discuss them all in uniform terms risks unduly impeding the efficient management of corporate groups.

Taking into account this debate within the Subcommittee, Chapter II, 1 of the Interim Proposal includes both Proposal A, which calls for the establishment of express provisions covering the liability of the Parent Company in cases where the Stock Company incurs a disadvantage as a result of a conflict of interests transaction between the Stock Company and the Parent Company, and Proposal B, which does not call for the establishment of express rules.

#### **(2) Specific Details of Proposal A**

A. Proposal A, first of all, states in Item (i) that if a Stock Company suffers a disadvantage as a result of a transaction with its Parent Company in which their interests conflict as compared to a hypothetical situation where that transaction did not take place, the Parent Company will owe a duty to pay to the Stock Company an amount equivalent to the disadvantage. This provision clearly applies the standard of whether the Stock Company incurred a disadvantage compared to a hypothetical situation where that transaction did not take place for determining the liability of the Parent Company pursuant to express provisions. Another conceivable standard for establishing the liability of the Parent Company could be whether the Stock Company incurred a disadvantage compared

to a hypothetical situation where the transaction took place based on terms that probably would have been agreed upon between independent parties (arms'-length standard), and it was pointed out that the existence of liability for dereliction of duty on the part of Directors in a conflict of interest transaction with a Director (Companies Act, Article 423) is determined on the basis of this arm's-length standard. However, the point was raised in the Subcommittee that formal and strict application of the arm's-length standard to conflict of interests transactions with a Parent Company ran the risk of impeding efficient management. Proposal A, taking the above debate into account, does not adopt the arm's-length standard with respect to the liability of the Parent Company pursuant to express provisions, but rather the standard of whether the Stock Company incurred a disadvantage as a result of the transaction as compared to a hypothetical situation where that transaction did not take place. However, in the establishment of express provisions in Proposal A there is no intention of affecting the abovementioned interpretations of current law. Therefore, even if Proposal A was adopted, these interpretations would not deny the possibility of pursuing the liability of a Parent Company, nor would there be impact on the standards for establishing the liability of a Parent Company according to these possible interpretations.

Further, Item (ii) states that the existence and the degree of the disadvantage suffered as a result of a conflict of interests transaction of a Stock Company with its Parent Company will be judged taking into account the terms of the transaction, as well as the terms of other transactions between the Stock Company and its Parent Company and all other circumstances. Because it is customary for various types of transactions to be carried out between a Stock Company and its Parent Company, with respect to whether there is liability on the part of the Parent Company, not just single transactions but the overall continuing relationship between the Parent Company and Subsidiary should be considered. Among the other matters to be considered could include the terms of other transactions with the Parent Company and the allocation of business opportunities between the Parent Company and Stock Company. Additionally, with respect, among other things, to transactions occurring over an extended period, in a case where agreement was reached on conditions that in light of such factors as the course of negotiations leading to a transaction were reasonable at the time such transaction conditions were decided, it would be possible to account for such circumstances, and even if subsequent changes to circumstances resulted in the Stock Company's incurring a loss, this would not directly lead to Parent Company liability.

The cumulative effect of Items (i) and (ii) is that liability of a Parent Company pursuant to express provisions based on Proposal A would occur in the amount equivalent to the disadvantage only in such instances where, in a conflict of interests transaction between a Parent Company and Subsidiary, taking into account every other circumstance, it could be said that the Stock Company suffered a disadvantage as a result of the transaction as compared to a hypothetical situation where that transaction did not take place (for example,

an instance where a Stock Company produced products for the Parent Company and, as a result of selling the products to the Parent Company at an unduly low price below the cost of production, incurred a loss and, after taking into account every other circumstance, it could be said that the Stock Company suffered a disadvantage).

In light of the foregoing, the significance of the express provisions of Proposal A is that, in light of the danger that in a conflict of interests transaction between the Parent Company and the Subsidiary, a Parent Company will pursue its own interests at the sacrifice of the Subsidiary, in a case where the Stock Company has affirmatively suffered a disadvantage in a conflict of interests transaction with its Parent Company, it is possible to pursue the liability of the Parent Company without having to concretely specify the form that the exercise of influence by the Parent Company took, and without the assumption of the Directors of such Stock Company bearing liability.

- B. Furthermore, if liability of the Parent Company pursuant to the express provisions of Proposal A arises, there is a danger that the Stock Company will not appropriately pursue such liability due to the influence of the Parent Company through its voting rights at Shareholders Meetings. In order to ensure the effective protection of Subsidiary minority shareholders, Item (iv) of Proposal A, by providing that the Parent Company liability pursuant to the express provisions of Item (i) is subject to actions pursuing Directors' liability (Companies Act, Article 847(1)), enables the pursuit of that liability by means of a derivative action, and Item (iii) provides that the liability may not be waived without the consent of all shareholders of the Stock Company.
- C. The grounds for the express provisions of Proposal A are sought in the influence on a Stock Company through the exercise of voting rights at a Shareholders Meeting. Typically, the first person thought to have such influence would be the Parent Company of the Stock Company (see Item (i)). However, the abovementioned grounds hold just as well for a natural person who, typically, in view of factors such as the ratio of voting rights he/she holds, could have influence equivalent to that of a Parent Company. For that reason the Note to Proposal A states that provisions corresponding to Items (i) through (iv) will also be established for the liability of such a natural person.

### **(3) Other Related Points at Issue Debated in the Subcommittee**

- A. There was debate in the Subcommittee about the protection of Subsidiary creditors as well. However, in the case that the express provisions of Proposal A are established, Subsidiary creditors could pursue liability through the exercise of an obligee's subrogation right (Civil Code, Article 423). Furthermore, even if, hypothetically, the liability of the Parent Company were waived with the consent of all the Subsidiary shareholders, there would be cases where it would be possible to rescind the manifestation of intention of waiver by exercise of an obligee's right to demand rescission of fraudulent act (Civil Code, Article 424). For that reason the Interim Proposal does not contain any new scheme for the protection of Subsidiary creditors.

B. Comment was also made in the Subcommittee that subject to (i) a new controlling shareholder of a Stock Company appearing or (ii) a controlling shareholder holding nine tenths (9/10) or more of the voting rights of all shareholders, a system should be established giving minority shareholders the opportunity to sell the shares they own in the Stock Company to the controlling shareholder (sell-out system). The sell-out system premised on (i) above (system for sell-out to a new controlling shareholder) can be viewed as a system for protecting minority shareholders by offering them the opportunity to withdraw if change occurs in the controlling shareholder; however, it was pointed out that there was danger of increase in expenses relating to business combination formation, rendering it more difficult to form business combinations for increasing corporate value. Further, because the sell-out system premised on (ii) above (system for sell-out to a super majority controlling shareholder), unlike the system for sell-out to a new controlling shareholder, is difficult to view as a system for offering to minority shareholders the opportunity to withdraw because of a change in controlling shareholder, it is necessary to carefully consider the objectives and purport of such a system. Therefore, neither of these systems appears in the Interim Proposal.

## **2. Enhanced Disclosure of Information**

Under current law, with regards to material transactions with a Parent Company, the nature of the transactions, the amount of the transactions by type of transaction, the terms of the transactions and the policy for deciding the terms of transactions must be indicated in the “notes concerning transactions with related persons” in the notes to non-consolidated financial statements (Ordinance on Company Accounting, Article 98(1)(xv) and Article 112) and in the supplementary statements (Ordinance on Company Accounting, Article 117), and the appropriateness of the indications made in the notes to non-consolidated financial statements and in the supplementary statements is subject to the auditor’s opinion of Accounting Auditors and Company Auditors (Companies Act, Article 436(1), (2)(i); Ordinance on Company Accounting, Article 122(1)(ii) and Article 126(1)(ii) et al.). In this regard, the comment was made in the Subcommittee that because of the danger that conflict of interests transactions with a Parent Company are typically disadvantageous to the Subsidiary, the disclosure of information to Subsidiary minority shareholders should be further enhanced.

For that reason, Chapter II, 2 of the Interim Proposal states that, with regards to transactions between a Stock Company and its Parent Company etc. indicated in the notes to non-consolidated financial statements or the supplementary statements, the provisions relating to disclosure of information in auditor’s reports etc. shall be enhanced. Specifically, in regards to those transactions indicated in the notes to non-consolidated financial statements etc. that are transactions between the Stock Company and its Parent Company (or a natural person who could be considered to have influence equivalent to a Parent Company), it is could be required, among other things, that the opinion of a Company Auditor be set forth in audit reports.

### **III. Cash Out**

#### **1. Share Sales Request, etc. by Special Controlling Shareholder**

##### **(1) Establishment of a System**

The comment was made that a cash-out system (forcing out minority shareholders by payment in cash) has merit in terms of the realization of flexible management based on a long-term perspective, speeding up the decision-making process by eliminating the procedures needed for Shareholders Meetings and the reduction of costs involved in legal compliance with regard to the obligations for the submission of securities reports etc., and in shareholder administration.

Under current law, a Reorganization with monies as consideration (e.g., Share Exchange) is a primary method for implementing a cash-out. In this case, in principle, a special resolution of a Shareholders Meeting of the Stock Company (“Subject Company”) which issued the shares subject to the cash-out is required (Companies Act, Article 783(1) and Article 309(2)(xii)); however, if the shareholder implementing the cash-out (surviving company, etc.) holds nine tenths (9/10) or more of the voting rights of all shareholders of the Subject Company (Absorbed Stock Company, etc.), using the procedures for a short-form reorganization, a resolution of a Shareholders Meeting of the Subject Company is not required (Companies Act, Article 784(1)).

Another method would be to deliver the proceeds from the sale of fractional shares in the processing of fractional shares after having once made the shares of minority shareholders into fractional shares through an acquisition of Class Shares subject to Wholly Call with shares paid as consideration. This is said to be the prevalent type of cash-out method, due to practical and tax considerations. However, because there is no system in place for eliminating the requirement for a resolution of a Shareholders Meeting, as in the case of a short-form reorganization, in an acquisition of Class Shares subject to Wholly Call, a special resolution of a Shareholders Meeting of the Subject Company is always required for this type of cash-out (Companies Act, Article 171(1) and Article 309(2)(iii)). It was pointed out that, for that reason, it takes a long time to complete a cash-out and the cost is high in terms of the time and procedures required. It was also commented that a cash-out is often preceded by a tender offer and in cases where a lengthy period of time is required from the completion of the tender offer until the cash-out, during that period, the shareholders who do not respond to the tender offer are put in an uncertain position and therefore the pressure of the tender offer rises (in other words, the likelihood is high that even those shareholders who feel that the purchase price under the tender offer is inadequate may end up tendering their shares simply in order to avoid the disadvantage arising from not doing so).

For that reason Chapter III, 1 of the Interim Proposal, from the point of view of reducing the costs in terms of time and procedures required to carry out a cash-out and ensuring that proper consideration is paid to minority shareholders in the course of the series of

procedures for carrying out the cash-out, calls for establishing a new system (hereinafter in this Section 1, the “System”) for a shareholder holding nine tenths (9/10) or more of the voting rights of all shareholders of the Subject Company to implement a cash-out without the requirement of a resolution of a Shareholders Meeting of the Subject Company. Items (i) through (xvi) specify the basic outlines of the System, the procedures for a Demand for Sale of Shares and the methods of remedy for Selling Shareholders as follows; but as stated in the note at the end of Chapter III, 1 of the Interim Proposal, additional necessary provisions will be established with respect to other procedures etc. concerning the Demand for Sale of Shares.

The System adds a new a method, different from the others, for implementing a cash-out that can be used by a shareholder holding nine tenths (9/10) or more of the voting rights of all shareholders of the Subject Company; its creation is not intended to effect a change of the rules under current law relating to the other methods for carrying out a cash-out.

## **(2) Basic Outline of the System**

Items (i) and (ii) describe the basic outline of the System.

First of all Item (i) provides that the Special Controlling Shareholder of a Stock Company may make demand to all shareholders of the Subject Company (excluding the Special Controlling Shareholder and the Subject Company; hereinafter the “Selling Shareholders”) for sale of all their shares to the Special Controlling Shareholder. A “Special Controlling Shareholder” means a person who holds nine tenths (9/10) or more of the voting rights of all shareholders of the Subject Company (see the note to Item (i)). This is modeled on the definition of a Special Controlling Company, which may use the procedures for a short-form reorganization (Companies Act, Article 468(1)). As is the case of the definition of Special Controlling Shareholder, the nine tenths (9/10) of the voting rights of all shareholders of the Subject Company are not required to be held directly but may also be held indirectly through a Stock Company etc. that owns all the Issued Shares; details about the foregoing will be addressed by provisions in a Ministry of Justice ordinance similar in purport to the provisions concerning the definition of a Special Controlling Company (Ordinance for Enforcement of the Companies Act, Article 136). The requirement that, if the Articles of Incorporation of the Subject Company specify a ratio higher than nine-tenths (9/10), voting rights must be held at such ratio or higher, parallels the definition of a Special Controlling Company. However, in contrast to a Reorganization, where the company is the party, the System takes the legal form of a sale and purchase of shares between shareholders. For that reason, also in contrast to the definition of a Special Controlling Company, if juridical persons other than companies and natural persons fulfill the above requirement regarding the holding of voting rights they too would fall under a Special Controlling Shareholder.

The reason the System is designed as a system for a Demand for Sale of Shares by the Special Controlling Shareholder is that, given that the benefits of a cash-out arise when a specific person acquires all the Issued Shares of the Subject Company, under the new System, which is to be created for facilitating cash-outs, in view of the objectives of cash-

outs, it would be simplest to provide for a direct transfer of the shares of minority shareholders to the Special Controlling Shareholder, and this would match the economic realities.

Although comment was made in the Subcommittee that Subject Companies in cash-outs under the System should be restricted to Public Companies under the Companies Act (Article 2(v)), from considerations of balance with cash-outs by other methods which have no such restriction under current law the Interim Proposal does not call for such a restriction.

Next, Item (ii) provides that if a Special Controlling Shareholder makes a Demand for Sales of Shares, he/she may also demand that the Share Option holders (excluding the Special Controlling Shareholder and Subject Company) of all the Share Options of Subject Company sell to the Special Controlling Shareholder all the Share Options they hold. In a case where the Subject Company has issued Share Options, if after the Special Controlling Shareholder has come to own all Issued Shares through a Demand for Sales of Shares, Share Options are exercised, the Share Option holders would become shareholders, and there is danger that the meaning of the cash-out would be lost. Allowing Share Options of the Subject Company to be included in demands for sale will contribute to the effectiveness of a cash-out by enabling a blanket processing of all Share Options etc. issued by the Subject Company. However, because Share Options attached to Bonds with Share Options may not in principle be detached from the bonds and assigned (see Companies Act, Article 254(2) et al.), further consideration will be given to their handling (see Note 1 to Item (ii)). In addition, the necessary provisions regarding procedures etc. concerning the Demand for Sale of Share Options and remedies for Share Option holders will be established in conformity with the rules concerning a Demand for Sale of Shares (see Note 2 to Item (ii)).

### **(3) Procedures for a Demand for Sale of Shares**

Items (iii) through (x) stipulate the procedures for a Demand for Sale of Shares.

First, Items (iii) and (iv) stipulate that a Special Controlling Shareholder intending to make a Demand for Sale of Shares, specifying the total amount of money (in other words, the consideration in the cash-out) to be paid to Selling Shareholders or the method of its calculation (see Item (iii)(a)), items concerning the allocation of the money (see Item (iii)(b); as stated in the note to Item (iii), it must be specified that the money be allocated in accordance with the number of shares held by the Selling Shareholders) and the date on which the Special Controlling Shareholder will acquire the shares (hereinafter in this Section 1, the “Acquisition Date”; see section (iii)(c)), must notify the Subject Company of its intent to make the above demand and obtain its consent therefor. Item (v) provides that when the Subject Company is a Company with Board of Directors, the decision on the consent shall be by resolution of its Board of Directors. Consent of the Subject Company is made a requirement for a Demand for Sale of Shares because, given that the price paid and the other terms of the cash-out are, as discussed above, decided by the Special Controlling Shareholder, it would not be proper from the standpoint of consideration of the interests of the Selling

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Shareholders to allow the cash-out on terms unilaterally set by the Special Controlling Shareholder; therefore, certain restrictions are necessary in regard to the terms of the cash-out. Given this purport, the Director (if the Subject Company is a Company with Board of Directors, then the Board of Directors) of the Subject Company, when consenting to a Demand for Sale of Shares, should consider whether the terms of the cash-out can be called fair when considering the interests of minority shareholders. In addition, in a case where such consent has been given, disclosure may be required of information about the deliberations held when giving the consent, including decisions concerning the reasonableness of the consideration offered in the cash-out, be disclosed, and the reasons therefor (see the note to Item (viii)).

Items (vi), (viii) and (x) specify the procedures the Subject Company must implement if it consents to the Demand for Sale of Shares. The Subject Company is not a party to the sale of the Shares pursuant to the Demand for Sales of Shares, but ensuring that the terms of the cash-out are known by having the Subject Company fulfilling a certain role in the disclosure of information to Selling Shareholders helps ensure the effectiveness of the remedies for Selling Shareholders (see Items (xi) through (xvi)). Item (vi) provides that when a Subject Company has given its consent to the Demand for Sale of Shares, it shall give notice to that effect to the Selling Shareholders no later than 20 days prior to the Acquisition Date, stating the name and address of the Special Controlling Shareholder and the terms of the cash-out. When the Subject Company is a Public Company, such notice may be made by public notice. The rationale for allowing public notice is that requiring individual notice could lead to an increase in costs in terms of time and procedures and balance is needed with other systems under current law, where notice to shareholders by public notice is allowed in the case of a Public Company (Companies Act, Article 158(2), Article 201(4) and Article 469(4)(i) et al.). Similarly, Items (viii) and (x) each specify certain advance and after-the-fact disclosure procedures, with the Subject Company fulfilling a certain role in the disclosure of information to Selling Shareholders. The procedures for advance disclosure of information in Item (viii) call for disclosure of the terms of the cash-out, but in addition, taking into account the role that the (Board of) Directors of the Subject Company should play in consenting to a Demand for Sale of Shares, other potential disclosure items include items concerning the reasonableness of the consideration paid in the cash-out (including the decision of the Director or Board of Directors concerning that matter and the reasons therefor) and matters included so that the interests of the Selling Shareholders are not harmed (including without limitation a valuation of the price of the shares by an outside party and the opinion of the Outside Directors). In the procedures for the after-the-fact disclosure of Item (x), matters concerning the Demand for Sale of Shares requiring disclosure could include such items as the number of shares of the Subject Company acquired by the Special Controlling Shareholder by the Demand for Sale of Shares as well as the course of events behind the procedures for the petition for determination of Acquisition Date and price.

Item (vii) states that when the Subject Company has given notice or made public notice as per Item (vi) above, the Special Controlling Shareholder shall be deemed to have made a Demand for Sale of Shares to the Selling Shareholders. This is to prevent the increase in costs in terms of time and procedures if the sale demand had to be made individually to each Selling Shareholder; and, from the standpoint of ensuring uniform legal treatment, notice or public notice to the effect that the Subject Company, which is in the position of fulfilling a certain role in the disclosure of information to Selling Shareholders, has consented to the Demand for Sale of Shares is considered to render unnecessary individual demands of sale. Item (ix) specifies the effect of the Demand for Sale of Shares and from the standpoint of ensuring uniform legal treatment, provides that on the Acquisition Date all shares to be sold will be transferred in aggregate to the Special Controlling Shareholder.

#### **(4) Remedies for Minority Shareholders**

Items (xi) et seq. specify remedies for Selling Shareholders. Because under current law, petition to a court for a determination of the selling price, request for an injunction and a suit challenging the validity of the cash-out are remedies available to minority shareholders in a cash-out, the System also provides for them.

##### **A. Petition for Decision on the Selling Price**

Items (xi) and (xii) set forth provisions concerning a petition to a court for a determination of the selling price in conformity with the provisions for acquisition of Class Shares subject to Wholly Call (Companies Act, Article 172). However, the rules differ in that, in contrast to an acquisition of Class Shares subject to Wholly Call, where the Stock Company acquiring the shares has the duty to pay the price decided by the court, under the System it is the Special Controlling Shareholder who must do so.

Item (xi) establishes the period for a petition for a determination of the selling price as the period from 20 days prior to the Acquisition Date until the day prior to the Acquisition Date (see Part 2, Chapter III, 2, (2)(ii) of the Interim Proposal in regard to similarly revising the period for petition for a decision on the acquisition price for Class Shares subject to Wholly Call), but the opinion was also voiced in the Subcommittee that, from the standpoint of the protection of Selling Shareholders, consideration should be given to allowing a petition also for a set period after the Acquisition Date. Under the System, unlike a Demand for Sale of Shares in a Reorganization or an acquisition of Class Shares Subject to Wholly Call, because the payment for the acquisition of the shares to be sold must be in money and, moreover, regardless of whether or not there is a petition for a determination of the selling price, the acquiring entity is always the Special Controlling Shareholder, the petition for a determination of the selling price can be viewed as purely a dispute over the price of the shares to be sold. Because for that reason such petition could be allowed even subsequent to the acquisition, the note to Item (xi) states that further consideration is required on this point while giving 20 days as an example of period length.

Item (xii) provides that the Special Controlling Shareholder shall pay interest on the price determined by the court calculated at the rate of six percent per annum from the Acquisition Date. This conforms to the rules regarding an acquisition of Class Shares subject to Wholly Call (Companies Act, Article 172(2)). In connection with this, again as in the case of a Demand for Sale of Shares in a Reorganization, a system should be established for payment for the shares prior to the determination of selling price in the Demand for Sale of Shares (see Interim Proposal, Part 2, Chapter IV, 2). Accordingly the note to Item (xii) calls for establishing the provisions needed to do so.

#### B. Request for Injunction

Item (xiii) allows for a request for injunction by a Selling Shareholder with respect to an acquisition of shares to be sold pursuant to a Demand for Sale of Shares. The acquisition of shares to be sold pursuant to a Demand for Sale of Shares, because unlike acquisition of Class Shares subject to Wholly Call and other methods of cash-out, there is no remedy through an action seeking rescission of a resolution of a Shareholders Meeting of the Subject Company (Companies Act, Article 831), allowing a request for injunction provides an alternative remedy for Selling Shareholders. The requirements for a request for injunction are modeled on the system for a request for injunction in a short-form reorganization (Companies Act, Article 784(2)), but in a Demand for Sale of Shares, because the Subject Company is not party to the transaction as in a Reorganization and therefore the demand is not likely to violate the Subject Company's Articles of Incorporation, Item (a) specifies as the only grounds for an injunction that the Demand for Sales of Shares be in violation of laws and regulations. At the same time, because a breach by the Subject Company of its duty for giving notice or public notice (see Item (vi)) or breach of the advance disclosure procedures (see Item (viii)) may not necessarily fall under a violation of laws and regulations by the Demand for Sale of Shares itself, Item (b) specifies such breaches as grounds for an injunction separate from those of Item (a). Item (c) makes a markedly unreasonable determination of the price a grounds for an injunction; this is the same as under the system for a request for an injunction in a short-form reorganization.

#### C. A Suit Challenging the Validity of Cash-out

Items (xiv) through (xvi) set forth a system for litigation seeking nullification of the acquisition of the sold shares.

In Item (xiv), because the acquisition of shares pursuant to a Demand for Sale of Shares impacts the interests of many shareholders, from the perspective of ensuring legal stability, the period for filing an action is restricted to within six months from the Acquisition Date. Additionally, taking into account legal stability and balance with other systems under current law, further consideration must be given regarding whether to make the period for filing an action one year if the Subject Company is not a Public Company (see Companies Act, Article 828(1)(ii) (parenthetical section), et al.). Furthermore, regarding the persons having the right to file an action, in addition to

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Selling Shareholders, Directors of the Subject Company or persons who were Directors of the Subject Company on the Acquisition Date are allowed the right to file an action, as persons in a position where their interests should also be considered.

Item (xv) specifies the Special Controlling Shareholder, who is the entity acquiring the shares to be sold, as the defendant in an action challenging the validity of the acquisition of the shares to be sold and, taking into consideration issues such as the location of evidence, stipulates that the district court with jurisdiction over the location of the headquarters of the Subject Company shall be the court with exclusive jurisdiction for the action.

Item (xvi), from the standpoint of ensuring legal stability and uniform legal treatment, stipulates that the final judgment shall have future effect and effect against third parties.

## **2. Rules Concerning the Acquisition of Class Shares Subject to Wholly Call**

### **(1) Enhanced Disclosure of Information**

The general rule under current law is that a cash-out will be implemented through an acquisition of Class Shares subject to Wholly Call. However, the point was raised that, compared to a Reorganization, the rules covering disclosure of information in an acquisition of Class Shares subject to Wholly Call are not adequate.

For that reason Chapter III, 2 (1) of the Interim Proposal calls for establishing the same advance disclosure procedures and after-the-fact disclosure procedures as in a Reorganization for an acquisition of Class Shares subject to Wholly Call as well.

Item (i) specifies the advance disclosure procedures. The text of Item (i) specifies as matters that must be disclosed matters concerning the consideration for the acquisition (Companies Act, Article 171(1)(i)), matters concerning the allocation of that money (Companies Act, Article 171(1)(ii)) and the Acquisition Date (Companies Act, Article 171(1)(iii)); however, taking into account that an acquisition of Class Shares subject to Wholly Call is used in a cash-out, the disclosure of information concerning the consideration paid to minority shareholders in a cash-out must also be enhanced. Because the consideration in this case will be the actual sales proceeds from the sale of fractional shares, the final amount cannot be disclosed in advance, but there could be prior agreement on such matters as the method of processing fractional shares and on the sale price of the fractional shares. For that reason, matters concerning the method of processing the fractional shares pursuant to Article 234 of the Companies Act and matters concerning the amount of money to be delivered to shareholders in the processing of the fractional shares (matters concerning the prospects for achieving that amount, matters concerning its appropriateness, etc.) are among the matters that could require disclosure (see the note to Item (i)).

Item (ii) specifies the after-the-fact disclosure procedures. It provides that the Stock Company must disclose the number of Class Shares subject to Wholly Call that it acquired and that Acquisition Date and the course of events behind the procedures for the petition for determination of price etc. could also be included in the matters requiring disclosure.

**(2) Rules Concerning the Petition for Determination of the Acquisition Price**

A. Under current law, when there is an acquisition of Class Shares subject to Wholly Call, shareholders who cannot exercise voting rights with respect to a resolution of a Shareholders Meeting pertaining to the acquisition (Companies Act, Article 171(1)) are allowed the right to petition for a determination of price (Companies Act, Article 172(1)(ii)); however, it was pointed out that because no provisions for notice or public notice to the effect that the acquisition will be carried out, the period for filing a petition may elapse without those shareholders being aware of the acquisition. It was also commented that because the period for filing a petition for determination of the acquisition price for Class Shares subject to Wholly Call is prescribed to be within 20 days from the date of the Shareholders Meeting at which the acquisition was decided (Companies Act, Article 172(1)(ii) (main paragraph)) the Acquisition Date could fall prior to the end date of the period for filing and if the determination of the acquisition price was made subsequent to the Acquisition Date there is a risk of complicated legal ramifications, including consideration already paid having to be returned.

For that reason Chapter III, 2 (2) (Items (i) and (ii)) of the Interim Proposal, modeled upon the rules concerning a Demand for Purchase of Shares pursuant to a Reorganization (Companies Act, Article 785(3-5), et al.), calls for revising the rules concerning a petition for determination of the acquisition price for Class Shares subject to Wholly Call. First, Item (i) provides that a Stock Company intending to acquire Class Shares subject to Wholly Call shall, at least 20 days prior to the acquisition date, notify all shareholders of Class Shares subject to Wholly Call of its intent to acquire the Class Shares subject to Wholly Call. Such notice may be made by public notice. Item (ii) provides that a petition for the determination of the acquisition price of the Class Shares subject to Wholly Call may be made during the period from 20 days prior to the acquisition date until the day prior to the acquisition date.

The above revisions seek to ensure that shareholders who have the right to file a petition for the determination of the acquisition price are made aware that an acquisition of Class Shares subject to Wholly Call is to be implemented, so that complicated legal ramifications resulting from a petition for determination of the acquisition price subsequent to the Acquisition Date can be avoided. In addition, taking into account that under current law an acquisition of Class Shares subject to Wholly Call is used as a cash-out method, these revisions will ensure consistency with the rules concerning a petition for determination of price pursuant to a Demand for Purchase of Shares in a Reorganization (Companies Act, Article 785, et al.) and a demand for purchase of fractional shares in a Consolidation of Shares (see Part 1, Chapter III, 2 (1) of the Interim Proposal) and will lead toward legal balance with the other cash-out methods.

B. Under current law, when the consideration for the acquisition of Class Shares subject to Wholly Call is specified as shares, bonds, Share Options or Bonds with Share Options, the shareholder of Class Shares subject to Wholly Call will acquire such consideration on

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the Acquisition Date (Companies Act, Article 173 (2)). However, it is not reasonable to stipulate that the same result consistently occur, even in the case of a petition being filed for determination of acquisition price.

For that reason Chapter III, 2 (2)(iii) of the Interim Proposal provides that express provisions will be established to the effect that the acquisition price stipulated in the resolution of the Shareholders Meeting will not be paid to shareholders who have made a petition for determination of the acquisition price.

### **3. Other Matters**

Under current law, there are no express provisions to the effect that persons who have lost shares as the result of a cash-out can file an action at law (Companies Act, Article 831) for the revocation of the resolution of a Shareholders Meeting etc. approving the cash-out. However, because such persons could potentially regain the position of shareholder if the resolution of a Shareholders Meeting etc. was revoked, their standing as plaintiff in an action for the revocation of the resolution of a Shareholders Meeting etc. should be allowed; and there has in fact been recent judicial precedent allowing this (see Tokyo High Court July 7, 2010 Decision, *Hanreijiho* [*Precedent Times*], No. 2095, p. 128).

For that reason Chapter III, 3 of the Interim Proposal states that express provisions will be established to the effect that persons who would become shareholders due to the revocation of a resolution of a Shareholders Meeting etc. may file an action for the revocation of such resolution.

Further, if the system for demand for purchase of fractional shares in conjunction with a Consolidation of Shares (see Part 1, Chapter III, 2 (1) of the Interim Proposal) is established, a Consolidation of Shares could be used for a cash-out. Because in that case a demand for purchase of fractional shares would serve as a remedy for minority shareholders in a cash-out, the note makes reference to that.

Comment was also made in the Subcommittee that with respect to a resolution of a Shareholders Meeting of the Subject Company for approval of a cash-out, requiring, for example, approval by at least nine tenths (9/10) of the voting rights of the shareholders present or approval by a majority of the shareholders other than the Special Controlling Shareholder, or otherwise making the requirements more stringent. However, it was pointed out in opposition to this that rules whereby a cash-out could be obstructed by the opposition of a portion of the minority shareholders were not reasonable and that there was concern that such leverage of minority shareholders could be misused; and because it was difficult to create appropriate rules also accounting for such cases as a tender offer being made in advance of a cash-out, uniformly making the requirements for a resolution more stringent, contrary to the intent of the revision, ran the risk of obstructing reasonable cash-outs; therefore, such requirements were not included in the Interim Proposal.

### **IV. Share Purchase Demand in a Reorganization, etc.**

## **1. Establishment of a Purchase Account**

Under current law, Dissenting Shareholders who have made a Share Purchase Demand may revoke that demand (Companies Act, 785(6), et al.) only if they obtain the consent of the Absorbed Stock Company, etc. (Companies Act, Article 782(1), Article 803(1)) or of the Surviving Stock Company, etc. (Companies Act, Article 794(1)) (hereinafter in these Sections 1 and 2 referred to collectively as a “Company”), which is counterparty to the Share Purchase Demand. This type of system for the revocation of a Share Purchase Demand was newly established when the Companies Act was enacted in 2005 in order to prevent misuse of Share Purchase Demands (for example, after making a Share Purchase Demand for shares having a market price, keeping an eye on subsequent market price trends, and if it becomes advantageous to sell the shares on the market, revoking the Share Purchase Demand and selling the shares on the market; or other speculative uses of a Share Purchase Demand). However, the point was raised that even subsequent to the establishment of this system for the revocation of Share Purchase Demands, a Dissenting Shareholder, by selling his/her shares on the market, can in actuality revoke a Share Purchase Demand without the consent of the Company.

For that reason, in order to make the restriction on the revocation of a Share Purchase Demand more effective, when the shares pertaining to the Share Purchase Demand are Book-Entry Shares, as defined in Article 128(1) of the Act on Book-Entry Transfer of Company Bonds and Shares, etc. (hereinafter the “Act on Book-Entry Transfer”), Chapter IV, 1 of the Interim Proposal provides that Dissenting Shareholders shall, concurrently with making such demand, in order to make the transfer of the shares pertaining to the Share Purchase Demand, apply for a transfer of the Book-Entry Shares pertaining to their demand for purchase, such transfer to be made to the account established pursuant to the application of the Company (the “Purchase Account”) (see the main text of Item (iii)) and that if a Dissenting Shareholder does not make the abovementioned application for transfer of his/her shares pertaining to the Share Purchase Demand, his/her demand will not take effect (see the note to Item (iii)).

Items (i) and (ii) stipulate the rules pertaining to Purchase Accounts. Item (i) provides that a Company issuing Book-Entry Shares shall without delay subsequent to the conclusion of an agreement or preparation of a plan concerning an Absorption-type Merger etc. or Consolidation-type Merger etc. (hereinafter referred to collectively as a “Reorganization”) apply to a book-entry transfer institution etc. for the establishment of a Purchase Account. (Of course, if the Company has already established a Purchase Account it does not need to make such application.) In order to ensure that that Dissenting Shareholders are informed of the Purchase Account, Item (ii) provides that matters concerning the Purchase Account shall be added to the matters set forth in the public notice in lieu of notice to shareholders pursuant to Article 161(2) of the Act on Book-Entry Transfer.

Items (iv) through (vi) stipulate the handling of the Book-Entry Shares entered or recorded in the Purchase Account. In order to prevent transfer to a Company’s own account despite the purchase not yet being effective, Items (iv) and (v) stipulate when a Company may apply for transfer to its own account of the shares pertaining to the Share Purchase Demand recorded in

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the Purchase Account. In other words, Item (iv) provides that until the purchase of the subject Book-Entry Shares becomes effective, namely, when the Surviving Stock Company, etc., the Splitting Stock Company in Absorption-type Company Split or the Splitting Stock Company in Incorporation-type Company Split pays the Dissenting Shareholder the price (excluding the payment prior to share valuation of Chapter IV, 2 of the Interim Proposal) for the Book-Entry Shares pertaining to the Share Purchase Demand (Companies Act, Article 786(5)(parenthetical section), Article 798(5), et al.), it may not make application to transfer those shares to its own account. Further, Item (v) provides that an Absorbed Stock Company, etc. (excluding a Splitting Stock Company in Absorption-type Company Split and a Splitting Stock Company in Incorporation-type Company Split) may not make application to transfer those shares to its own account until the purchase of the subject Book-Entry Shares becomes effective, namely, the effective date of the Reorganization (in an Absorption-type Merger or Share Exchange, the day specified as the effective date of the Absorption-type Merger Agreement or the Share Exchange Agreement; in a Consolidation-type Merger or Share Transfer, the date of the establishment of the Company Incorporated through Consolidation-type Merger or the Wholly Owing Parent Company Incorporated through Share Transfer) (Companies Act, Article 786(5) et al.). On the other hand, given that after a Share Purchase Demand has been revoked the reason for entering or recording the Book-Entry Shares pertaining to that Share Purchase Demand in the Purchase Account no longer exists, conversely with Items (iv) and (v), Item (vi) specifies the procedures for transfer to the account of the Dissenting Shareholder from the Purchase Account. In other words, Item (vi) provides that, if after the Book-Entry Shares pertaining to the Share Purchase Demand have been transferred to the Purchase Account the Company consents to the revocation of the Share Purchase Demand by the Dissenting Shareholder, the Company shall immediately apply for transfer of the Book-Entry Shares pertaining to that demand to a transfer account that is an account of the Dissenting Shareholder.

Because in addition to the foregoing matters regarding the establishment of the Purchase Account other additional technical matters concerning transfers to a Purchase Account need to be specified, Note 1 states that the necessary provisions will be established with respect to transfers etc. to a Purchase Account. An example of such a technical matter is that the notice of all shareholders to the Company (Act on Book-Entry Transfer, Article 151) should include Dissenting Shareholders as shareholders because even after the shares pertaining to the Share Purchase Demand have been entered or recorded in the Purchase Account, until the purchase of shares pertaining to the Share Purchase Demand becomes effective (Companies Act, Article 786(5), et al.), a Dissenting Shareholder does not lose his/her position as a shareholder. Another example would be to prohibit an application for transfer of the Book-Entry Shares to an account other than an account of the Company or a Dissenting Shareholder.

In view of the need to ensure the effectiveness of the restrictions on the revocation of a Share Purchase Demand in the case of a Share Purchase Demand related to an amendment etc. of the Articles of Incorporation pertaining to Class Shares (Companies Act, Article 116) and a Share Purchase Demand in an Assignment of Business (Companies Act, Article 469), in the same

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manner as in the case of a Reorganization, Note 2 calls for the establishment of rules similar to those in the main text. (See the note at the end of Part 1, Chapter III, 2 (1) of the Interim Proposal which, for the same reasons, provides for establishing rules similar to those in the main text with respect to the demand for purchase of fractional shares resulting from a Consolidation of Shares.) Additionally, Note 3, for the same reasons, provides for the establishment of similar rules with respect to a demand for purchase of Share Options (Companies Act, Article 787 et al.).

## **2. System for Payment Prior to the Determination of Price for Shares, etc., pertaining to a Share Purchase Demand**

Under current law, when a petition has been made to a court for a determination of the price of shares pertaining to a Share Purchase Demand, an Absorbed Stock Company etc. or a Surviving Stock Company etc. shall pay interest on the price determined by the court calculated at the rate of six percent per annum from the day after the end of the 60 day period starting from the Effective Date of the Reorganization (Companies Act, Article 786(4), et al.). However, the point was raised that in light of current economic conditions, an interest rate of six percent per annum has invited abuse of Share Purchase Demands. It was also commented on this point that as a practical matter, as a means for quick payment and a resulting reduction in interest payments, there would be sometimes agreement between the Company and Dissenting Shareholders on payment of a certain amount for the shares pertaining to the Share Purchase Demand prior to the price being determined by the court.

Accordingly, from the standpoint of reducing the payment of interest of a Company and preventing the abuse of Share Purchase Demands, by allowing for a Company to make a payment of a certain amount prior to the price of the shares being determined, Chapter IV, 2 of the Interim Proposal provides that when there is a Share Purchase Demand, the Company may pay an amount it judges to be a fair price to Dissenting Shareholders prior to the price of the shares being determined (see main text) and if a Company makes payment under this system, notwithstanding the provisions of Article 786(4) and elsewhere in the Companies Act, the Company does not owe a duty to pay interest on the amount of that payment subsequent to such payment (see Note 1). Accordingly, the total amount that will be payable by a Company to Dissenting Shareholders when the price of the shares is determined could be (a) the amount a Company paid as the fair price and the interest (only in cases where payment is made subsequent to the interest start date) on that amount from the interest start date (the day marking the elapse of 60 days from the Effective Date of the Reorganization or from the day of incorporation of the incorporated company) until the date of the payment or (b) the difference between the amount a Company paid as the fair price and the amount determined as the price of the shares pertaining to the Share Purchase Demand and the interest on that difference.

Further, for the same reasons, Notes 2 and 3 call for establishing similar rules with respect to Share Purchase Demands in a revision to Articles of Incorporation, etc., pertaining to Class Shares (Companies Act, Article 117(4)), petitions for a determination of the price pertaining to

the acquisition of Class Shares subject to Wholly Call (Companies Act, Article 172(2)) and Share Purchase Demands in an Assignment of Business (Companies Act, Article 470(4)), in regards to all of which there is a duty to pay interest of six percent per annum on the amount determined by the court, as well as to Share Option Purchase Demands (Companies Act, Article 778(4) et al.)(see the note at the end of Part 1, Chapter III, 2 (1) and the note to Part 2, Chapter III, 1 (xii) of the Interim Proposal which for the same reasons provide for establishing similar rules with respect to demands for purchase of fractional shares in a Consolidation of Shares and petitions for the determination of price when a Demand for Sale of Shares is made by a Special Controlling Shareholder).

Further, under current law, no specific provisions exist that address the matter of whether a Dissenting Shareholder, after having made a Share Purchase Demand, has the right to receive dividends from surplus or hold voting rights, etc., during the period until the Share Purchase Demand becomes effective, although there has been a judicial precedent affirming the right to receive dividends from surplus. On this point, opinion in the Subcommittee was divided, with on the one hand the opinion being voiced that, inasmuch as Dissenting Shareholders receive statutory interest on the shares pertaining to the Share Purchase Demand, they should not have the right to receive dividends from surplus, and that it was acceptable to deny the right of Dissenting Shareholders to receive dividends from surplus subsequent to the “Reference Date” for the determination of the fair price, and on the other hand the opinion being voiced that because Dissenting Shareholders do not forfeit the position of shareholder until the Share Purchase Demand becomes effective their right to receive dividends from surplus should not be denied. For that reason Note 4 states that further consideration is required of whether Dissenting Shareholders, after making a Share Purchase Demand, should have the right to receive dividends from surplus from the shares pertaining to the demand.

### **3. Share Purchase Demand in a Simplified Reorganization, etc.**

Under current law, when the requirements for a simplified reorganization are satisfied in a Surviving Company etc. (Companies Act, Article 796(3)), or when the requirements for a simplified Assignment of Business are met in the transferee company (Companies Act, Article 468(2)), all shareholders of the Surviving Company or the transferee company have the right to demand the purchase of shares (Companies Act, Article 797(2)(ii), Article 469(2)(ii)). However, the point was made that, in contrast to the intent of the system for Share Purchase Demands, which is to give the shareholder who opposes the implementation of substantial change to the foundations of a company’s organization the opportunity to recover his/her invested capital, current law does not require a resolution of shareholders for a simplified reorganization or simplified Assignment of Business because the impact of a simplified reorganization on a company and its shareholders is minor; in view of this, a simplified reorganization or a simplified Assignment of Business cannot be said to be an act causing substantial change to foundations of an organization, and when a company carries out such an act Dissenting Shareholders should not have the right to demand the purchase of shares.

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On this point, when a simplified merger, simplified Share Exchange and a simplified split are each examined by type, first of all, because the impact of a simplified Share Exchange on the assets and liabilities of the Wholly Owning Parent Company in Share Exchange is small, it could be considered unnecessary to allow a Share Purchase Demand to Dissenting Shareholders of the Wholly Owning Parent Company in Share Exchange. Next, when considering a simplified merger and a simplified split, the danger of hidden liabilities in the businesses assumed by the Stock Company Surviving Absorption-type Merger or the Succeeding Company in Absorption-type Company Split cannot be denied. However, in cases where there exists such a danger of hidden liabilities, shareholders who oppose the simplified merger or simplified split, if they can mobilize a certain number of voting rights, may demand a resolution of a Shareholders Meeting (Companies Act, Article 796(4); if a resolution of a Shareholders' meeting is required pursuant to the provisions of Paragraph (4), Dissenting Shareholders have the right to demand the purchase of shares), and they may pursue liability for damages against Officers. etc. (Companies Act, Article 423); in light of this, in the cases of a simplified merger and a simplified split, unlike a simplified Share Exchange, there is little need to grant the right to demand the purchase of shares to Dissenting Shareholders of the Stock Company Surviving Absorption-type Merger or the Succeeding Company in Absorption-type Company Split. An argument similar to the foregoing could be made with respect to a simplified Assignment of Business in a transferee company.

In light of the above, Chapter IV, 3 of the Interim Proposal states that when the requirements for a simplified reorganization are satisfied in a Surviving Company, etc., or when the requirements for a simplified Assignment of Business are met in the transferee company, Dissenting Shareholders shall not have the right to demand the purchase of shares.

#### **4. The Endnote to Chapter IV**

Although the point was raised in the Subcommittee that, on the one hand, it was not necessary to give the protection of the right to demand the purchase of shares to persons who acquired shares in full knowledge of the specific terms of a Reorganization, comment was also made that when an improper Reorganization is being attempted to buy shares, it is not unreasonable to dissent at Shareholders Meetings and demand the purchase of shares. For that reason, the endnote to Chapter IV of the Interim Proposal states that further consideration is required of whether Dissenting Shareholders who have acquired shares after a Company has made a public notice regarding the terms of a Reorganization have the right to demand the purchase of shares.

#### **V. Request for Injunction on a Reorganization, etc.**

In cases where a short-form reorganization would violate laws or regulations or the Company's Articles of Incorporation or in cases where the consideration for such a short-form reorganization would be markedly unfair in light of the status of the company's assets or other circumstances and the shareholders are likely to suffer disadvantage, current law contains

explicit provisions allowing the shareholders to demand that the company refrain from effecting the short-form reorganization (Companies Act, Article 784(2), Article 796(2)). In contrast, current law does not contain any explicit provision allowing shareholders to seek an injunction with respect to any type of Reorganization other than a short-form reorganization. Among interpretations of current law, however, is the opinion that in cases where a markedly unfair resolution of the Shareholders Meeting approving a Reorganization is adopted through the exercise of voting rights by a person having special interests, the shareholders may seek an injunction preventing the Reorganization by petitioning for provisional disposition in an action seeking revocation of the Shareholders Meeting resolution (Companies Act, Article 831(1)(iii)). In contrast to this, interpretation of the Civil Provisional Remedies Act concerning provisional disposition to determine a provisional status (see Civil Provisional Remedies Act, Article 23(2)) denies the existence of a right to preservation in the absence of an explicit right to request an injunction under substantive law. It has been pointed out that these types of petitions for provisional disposition should be denied, and that, in light of this, there would be need to introduce through legislation a system for requests for injunctions against general reorganizations.

Current law also allows shareholders and creditors to file an action seeking to invalidate a Reorganization as a means of disputing the validity of a Reorganization (Companies Act, Article 828), but after a Reorganization takes effect, there is a danger that the legal relationships will be unstable because of the possibility of subsequent denial of the validity of the Reorganization. As a result, it has been suggested that an explicit provision should be adopted to allow shareholders to request an injunction stopping Reorganizations other than short-form reorganizations (excluding simplified reorganization that will have de minimis effects on shareholders) as a means of a prior remedy.

In light of the above, the Subcommittee members were of various opinions including the opinion that expresses rules concerning petitions by shareholders for injunctions preventing Reorganizations should be adopted as well as the opposing opinions that if such rules concerning petitions by shareholders for injunctions stopping Reorganizations were adopted, there is the danger of a chilling effect on the implementation of Reorganizations and that there is a danger of abuse of petitions seeking to stop Reorganizations.

Chapter V of the Interim Proposal contains two proposals concerning Reorganizations other than short-form reorganizations (excluding cases where the requirements for a short-form reorganization are satisfied): Proposal A provides for the establishment of explicit provisions allowing shareholders to request that a Reorganization shall be stopped, and Proposal B, which provides that no explicit provisions shall be established.

With regard to the requirements for an injunction in the case where explicit provisions concerning injunctions to stop Reorganizations are established, it was pointed out in the Subcommittee that there is need for clarity concerning the requirements for an injunction, and that in actuality, it is expected that a shareholder request for an injunction to stop a Reorganization will be fought with a petition for provisional disposition, and the court will be

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requested to review the case quickly and if simply unfairness of consideration is the requirement for an injunction, it will be extremely difficult for the court to review the matter quickly. Consequently, the body of Proposal A makes reference to Article 784(2)(i) of the Companies Act, which provides for injunctions to stop simplified reorganizations and establishes as the requirements for shareholders of an Absorbed Stock Company to stop a Reorganization that “the Absorption-type Merger, etc. violates the applicable laws and regulations or Articles of Incorporation” and contains a similar provision applicable to the Surviving Company, etc. The violation of applicable laws and regulations or Articles of Incorporation specified in that section is generally understood not to include the duty of due care or the duty of loyalty, and accordingly, violations of “laws and regulations or the Articles of Incorporation” specified in Proposal A would likely be subject to a similar interpretation.

Note 1 indicates that, in light of the need discussed above for clarity concerning the requirements for injunctions, further consideration is required concerning the question of whether, in addition to cases of violation of laws and regulations or the Articles of Incorporation, shareholders should have the ability to request that a Reorganization be stopped in cases where a markedly unfair resolution of the Shareholders Meeting is passed or is likely to pass due to the exercise of voting rights by a person having special interests and there is thus a likelihood that the shareholders may suffer disadvantage. If explicit requirements for injunctions in the cases specified in Note 1 to Proposal A are not established, it seems likely that the interpretation allowing shareholders to seek an injunction stopping a Reorganization in such cases would be denied.

Further, Note 2 states that if Proposal A is adopted, similar rules will be established with respect to acquisition of Class Shares subject to Wholly Call (Companies Act, Article 171), Consolidation of Shares (Companies Act, Article 180), and Assignment of Business, etc. (Companies Act, Article 467), which are all similar to a Reorganization in that there is a danger of instability in the legal relationships because of the possibility of subsequent denial of the validity of the Reorganization based on shareholders suffering disadvantage as a result of the company’s actions.

## **VI. Protection of Creditors in a Company Split, etc.**

### **1. Protection of Creditors in a Fraudulent Company Split**

(1) Under current law, in the case of what is called a “butteki” split (as defined below), creditors of a Splitting Company in an Absorption-type Company Split or Splitting Company in an Incorporation-type Company Split (hereinafter referred to as a “Splitting Company”) that can demand performance of financial obligations by the Splitting Company are not subject to the procedures for creditors to state objections (see Companies Act, Article 789(1)(ii) et al.). The reason for this is that in the case of a butteki split, the Splitting Company receives shares of the Succeeding Company in an Absorption-type Company Split or the Company Incorporated through Incorporation-type Company Split (hereinafter referred to as a “Succeeding Company, etc.”) equal in amount to the net assets transferred to the Succeeding Company, etc., and

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therefore, the Splitting Company can indirectly know that value of the assets transferred to the Succeeding Company, etc. through its ownership of the shares of the Succeeding Company, etc. and so there will be no change in the Splitting Company's financial status.

On the other hand, it has been pointed out recently that Splitting Companies have arbitrarily selected those creditors that can demand that the Succeeding Company, etc. perform obligations from those creditors that cannot demand performance (hereinafter referred to as the "Remaining Creditor(s)") and effect company splits that harm the Remaining Creditors by transferring high-quality business or assets to the Succeeding Company, etc. or through other means (fraudulent company splits).

In order to protect Remaining Creditors from this type of fraudulent company split, there is judicial precedent that recognizes exercise of the right to rescind fraudulent acts under the Civil Code (Article 424) as policy under the current Companies Act (see Tokyo High Court Decision of October 27, 2010, *Kinhan* No. 1355, p. 42 et al.). With respect to this, it would be appropriate to establish an explicit provision in the Companies Act for the protection of Remaining Creditors in fraudulent company splits rather than relying solely on the general principles of civil law such as the right to demand rescission of fraudulent acts.

It was commented in the Subcommittee that rather than uniformly establishing redundant procedures for company splits, a limited review should be performed to the extent necessary to protect Remaining Creditors in fraudulent company splits. Also, when performing such a review, it is necessary to take into consideration the interests of creditors of the post-split Splitting Company that cannot demand performance of obligations by that company (hereinafter referred to as "Succeeding Creditors") and of creditors of the Succeeding Company, etc. that existed prior to the company split.

Company splits are generally used for business Reorganization, and usually the Succeeding Company, etc. succeeds to a business from the Splitting Company. In the case of a fraudulent company split, if the assets constituting the business transferred from the Splitting Company must be returned, there will be a danger of harm to the continuation of the business by the Succeeding Company, etc. and of harm to the interests of employees, trading partners, and others involved in that business.

According to judicial precedent, the method of restoration to the original state following exercise of the right to demand rescission of a fraudulent act under the Civil Code is, in principle, the in-kind return of the assets that were relinquished (Supreme Court decision of November 30, 1934, *Minshu* Vol. 13, No. 23, p. 2191, et al.), but in the case of a fraudulent company split, because the Succeeding Company, etc. has continued the business assumed from the Splitting Company, the assets succeeded to may have changed, and there is judicial precedent that allows compensation on the amount of the assets relinquished in place of in-kind return on the grounds that it would be infeasible for Remaining Creditors to identify and force the return of assets succeeded to by the Succeeding Company, etc. (Tokyo District Court Decision of May 27, 2010, *Hanji* No. 2083, p. 148).

In light of the above, for the protection of Remaining Creditors in fraudulent company splits, it would be appropriate and direct to allow direct demand of payment against to the Succeeding Company, etc. In addition to the right to demand rescission of fraudulent acts under the Civil Code, a provision should be added to the Companies Act that enables Remaining Creditors to demand that the Succeeding Company, etc. perform financial obligations without seeking rescission of the conduct relating to the fraudulent company split.

With respect to the limitation of liability of the Succeeding Company, etc. in the case of a “jinteki” split (see Companies Act, Article 758(viii) et al.), Remaining Creditors that did not receive separate notice can in principle demand performance of obligations by the Succeeding Company, etc. to the extent of the value of property to which it succeeded (Companies Act, Article 759(3), et al.), and with regard to the right to demand rescission of fraudulent acts under the Civil Code, it is necessary to take into consideration a balance with the limitation of the liability of persons who gained benefit from the fraudulent acts and subsequent purchasers to the extent of the value of the assets that were the target of the fraudulent acts. In addition, it is necessary to take into consideration the interests of Succeeding Creditors and creditors of the Succeeding Company, etc. that existed prior to the company split, and therefore, it is appropriate to limit the liability of the Succeeding Company, etc. to the value of the assets to which is succeeded from the Splitting Company.

Based on the above, Section VI(1)(i) of the Interim Proposal provides that in the case where a Splitting Company effects a company split knowing that it would harm its creditors, the Remaining Creditors may demand that the Succeeding Company perform the obligations of the Splitting Company up to the amount of the assets succeeded to; however, in Item (i), referring to the proviso of Article 424(1) of the Civil Code, in the case of an Absorption-type Company Split where the Succeeding Company did not know at the time the Company Split became effective that the Remaining Creditors would be harmed, the right to make the demand pursuant to Item (i) does not arise, and it is necessary to establish bad faith on the part of the Succeeding Company to the Absorption-type Company Split. In contrast to this, in the case of an Incorporation-type Company Split, because the company split becomes effective on the day of establishment of the Company Incorporated through Incorporation-type Company Split (see Companies Act, Article 764(1) et al.), it is not reasonable to have knowledge by the Company Incorporated through Incorporation-type Company Split at the time that the company split becomes effective as a requirement, and consequently, bad faith on the part of the Company Incorporated through Incorporation-type Company Split is not a requirement.

Also, under the note to Item (i), in the case of a “jinteki split”, the Remaining Creditors do not acquire the right to make such a demand under Item (i) since they have the opportunity to object to the company split (Companies Act, Article 789(1)(ii) et al.).

With respect to the question of whether any company splits “harm” Remaining Creditors, fundamentally, company splits are interpreted in the same manner as the legal conduct that “harms creditors” specified in the body of Article 424(1) of the Civil Code, which provides for rescission of fraudulent acts. According to judicial precedents, in cases where an insolvent

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Splitting Stock Company in Incorporation-type Company Split separated its underperforming business and retained other business by transferring most of its unsecured assets and a portion of its obligations to the Company Incorporated through the Incorporation-type Company Split (the obligations transferred to the Company Incorporated through the Incorporation-type Company Split are also assumed by the Splitting Company), loss of substance as the Splitting Company has been recognized and exercise of the right to rescind fraudulent acts by Remaining Creditors has been permitted (see May 27, 2010 decision of the Tokyo District Court and the October 27, 2010 decision of the Tokyo High Court affirming this decision).

(2) Item (ii) specifies the periods during which the right to make the demand provided in Item (i) can be made. In the case of a fraudulent company split, the right to make the demand provided in Item (i) imposes limited liability for physical resources (liability limited to the extent of the value of the assets succeeded to) on the Succeeding Company, etc., and the effect is similar to cases where compensation is granted in the amount of the value of the relinquished assets pursuant to the exercise of the right to rescind fraudulent acts. As a result, there is little need to specify for the right to make the demand provided in Item (i) an exercise period that differs from that of the right to demand rescission of a fraudulent act. Item (ii), in reference to Article 426 of the Civil Code, which sets the exercise period for the right to demand rescission of fraudulent acts, provides that if a Remaining Creditor does not make the demand provided in Item (i) or give advance notice of such demand within two years from the time of learning that the Splitting Company effected a company split specified in Item (i), the right to make the demand provided in Item (i) will extinguish at the time such period lapses and further provides that the right will extinguish after the passage of 20 years from the time when the Company Split took effect. The intent behind both exercise periods is to provide a statute of limitations. Further, advance notice of a demand is permitted in addition to the demand provided in Item (i) in consideration of cases where a Remaining Creditor is unable to make the demand provided in Item (i) within two years from the time of learning that the Splitting Company detected a company split that harmed the Remaining Creditor because of conditions or time limits attached to the claims that the Remaining Creditor holds against the Splitting Company (see Companies Act, Article 22(3)).

(3) If the right to make the demand provided in Item (i) is established, there could be the problem of protecting Succeeding Creditors and the creditors of the Succeeding Company, etc. that existed prior to the company split. With respect to this point, first, it is possible for these creditors to object to company splits where there is a possibility that the Succeeding Company, etc. will bear the liability specified in Item (i) (Companies Act, Article 789(1)(ii) and Article 799(1)(ii), et al.) based on the advance disclosure by the Splitting Company or the Succeeding Company, etc. (Companies Act, Article 782(1); Ordinance for Enforcement of the Companies Act, Article 183; Companies Act, Article 794(1); Ordinance for Enforcement of the Companies Act, Article 192, et al.). Further, in regards to the proviso of Item (i), in the case of an

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Absorption-type Company Split, bad faith on the part of the Succeeding Company in the Absorption-type Company Split, these creditors can pursue the liability of the Officers of the Succeeding Company in an Absorption-type Company Split who owe the liability specified in Item (i) for bad faith with respect to a fraudulent company split (Companies Act, Article 429 (1), et al.).

(4) In the note to Item (i), with respect to Assignments of Business that harm creditors who hold claims against the transferor company that are not transferred to the transferee company, circumstances similar to the protection of Remaining Creditors in a fraudulent company split are recognized (see the July 10, 2001 decision of the Nagoya District Court, *Hanji* No. 1775, p. 108 et al.); consequently, provisions equivalent to those indicated above relating to company splits are to be established.

## **2. Protection of Creditors from Tortious Acts**

Under the old Commercial Code, creditors eligible for the procedures for creditors to raise objections who “did not receive individual notice” could demand that both the Splitting Company and the Succeeding Company, etc. would perform obligations, regardless of the provisions of the split agreement or the split plan (old Commercial Code, Article 374-26(2) et al.). As a result, when creditors of obligations of the Splitting Company that arose from tortious conduct (“Tort Creditor(s)”) who were eligible for the procedures to raise objections to a corporate split did not receive individual notice, such creditors might demand that the Splitting Company and the Succeeding Company, etc. perform obligations, regardless of whether the Splitting Company knew.

In contrast to this, the Companies Act provides that of the creditors of a Splitting Company who can state objection to the Company Split, only those “to whom separate notice shall be given” may request both the Splitting Company and the Succeeding Company, etc. perform obligations if separate notice is not received (Companies Act, Article 759(2), et al.). Also, it was pointed out that the wording of the Companies Act, Article 789(2) and (3) could be read to mean that separate notice need not be provided to Tort Creditors who are entitled to state an objection to a Company Split and who are unaware of the Company Split, and therefore, there is a risk that Tort Creditors will be able to request performance by only one of the Splitting Company or the Succeeding Company, etc. and a request for performance of obligations by both will not be permitted.

With respect to this point, even the Companies Act has been interpreted to allow Tort Creditors who are entitled to state an objection to the Company Split and who are not aware of the Company Split to demand performance of obligations by both the Splitting Company and the Succeeding Company, etc., but unclear points remain, and it was pointed out that it would be desirable the make protection of creditors from tortious acts more certain through legislation.

(Reference Translation)

Chapter VI, 2 of the Interim Proposal provides that a Tort Creditor who is entitled to state an objection concerning the Company Split and who is not aware of the Company Split may demand performance of obligations by the Splitting Company and the Succeeding Company, etc.

### **3. Endnote to Chapter VI**

In the Subcommittee it was commented that it would be desirable to establish procedures for informing employees about business plans following a Reorganization, soliciting opinions from employees, and disclosing those opinions to shareholders for the purpose of serving as reference information when shareholders make decisions concerning the Reorganization or Assignment of Business by a Stock Company. In response, it was also commented that there would be no adequate basis for establishing such procedures with respect to employees only from among the wide scope of interested parties associated with a Stock Company and also that collecting and summarizing employee opinions would incur time and procedural costs, impeding the rapid implementation of a Reorganization. As a result, the endnote to Chapter VI of the Interim Proposal provides that further consideration will be given to the question of disclosure of employee opinions in the case of Reorganization by Stock Company.

## **Part 3. Other Matters**

### **I. Request for an Injunction against the Exercise of Voting Rights by Persons in Violation of Regulations under the Financial Instruments and Exchange Act**

#### **1. Establishment of a System**

Regulations under the Financial Instruments and Exchange Act include regulations relating to the acquisition and holding of shares, including regulations concerning Tender Offers, Report of Possession of Large Volume, and solicitation of proxies, but there are no provisions under current law prohibiting the exercise of voting rights in Shareholders Meetings by persons who violate these regulations.

As a result, it was suggested that from the perspective of maintaining the fairness of corporate control, a system should be established to prevent the exercise of voting rights relating to shares that were acquired or are held in violation of regulations under the Financial Instruments and Exchange Act. In response to this, the opinion was expressed in the Subcommittee that for sanctions against violations of regulations under the Financial Instruments and Exchange Act, the Administrative Monetary Penalty and other provisions under current law were adequate and that it was doubtful whether the management of Stock Companies have the incentive to make proper use of such a system, but the weight of opinion was in favor of the establishment of such a system.

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Chapter I, Part 3 of the Interim Proposal addresses whether it would be proper to create a system that enables a shareholder to seek an injunction against the exercise of voting rights by a shareholder in violation of certain regulations under the Financial Instruments and Exchange Act (hereinafter referred to as the “System”).

## **2. Scope of Subject Regulations**

A request for an injunction against the exercise of voting rights pursuant to the System may have a substantial impact on decision making concerning fundamental matters relating to a Stock Company, and if the System is used in an abusive manner, it may impede proper corporate operation giving rise to disorder in the practice of Shareholders Meeting. Based on this perspective, injunctions against the exercise of voting rights pursuant to the System should be allowed only in cases where violations of regulations under the Financial Instruments and Exchange Act would harm the interests of the Stock Company or other shareholders and prohibiting the exercise of voting rights by the violator is an appropriate means of protecting those interests.

The Interim Proposal suggests that the following regulations under the Financial Instruments and Exchange Act be subject to injunctions against the exercise of voting rights pursuant to the System: (i) Those regulations compelling Tender Offers which relate to the purchase of Share Certificates, etc., such that the Share Certificates, etc. Holding Rate would exceed one third (Financial Instruments and Exchange Act, Article 27-2(1)(ii-vi)); (ii) regulations imposing on the Tender Offeror the obligation to buy all shares (the obligation to effect delivery and other settlement pertaining to the purchase, etc., of all Share Certificates, etc. submitted) (Financial Instruments and Exchange Act, Article 27-13(4)); and (iii) regulations compelling a Tender Offeror to solicit all shares (the obligation to solicit offers to purchase, etc. all Share Certificates, etc., issued by the issuer of Share Certificates, etc., being purchased) (Financial Instruments and Exchange Act, Article 27-2(5); Cabinet Order for Enforcement of the Financial Instruments and Exchange Act, Article 8(5)(iii)). When major changes occur in the controlling relationship of a Stock Company, these regulations have the function of protecting the interests of shareholders by providing shareholders with the opportunity to sell the shares that they own, and if a Tender Offer for shares is made in violation of these regulations, an injunction preventing the exercise of voting rights by the violator can directly lead to the protection of the shareholder interests referenced above by preventing the acquisition of control by the violator. With respect to the regulations in (iii) above, however, the content thereof has been delegated in its entirety to Cabinet Order, and there is also the technical legal problem that the duty cannot be identified in the law, and accordingly, Note 1 indicates that further consideration will be made concerning treatment of violations of these regulations.

The Interim Proposal indicates that in the case of a violation of the regulations indicated above, voting rights are not automatically lost, and the violator is prevented from exercising voting rights only when an injunction is obtained. This is because if voting rights were lost

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automatically in the event of a violation, there may be an impact on the effects of prior exercise of voting rights and would be inappropriate from the perspective of legal stability.

### **3. Requirements for and Effects of Injunctions**

The effect of an injunction against the exercise of voting rights pursuant to the System extends not only to an individual Shareholders Meeting, but to all subsequent Shareholders Meetings, and consequently, such an injunction can have a significant effect on decision-making concerning the fundamental matters of a Stock Company. In light of this, even in cases of violations of the regulations specified in (i) through (iii) in Section 2 above, it would not be appropriate to grant an injunction preventing the exercise of voting rights when the violation is not material. As a result, the Interim Proposal would allow for injunctions to prevent the exercise of voting rights pursuant to the System only in cases where the violations are material.

In addition, under the Interim Proposal, shareholders other than the violator have the right to seek an injunction. In addition, although there were opinions within the Subcommittee supporting the right of the Stock Company to seek an injunction, it was pointed out that there are doubts whether the management representing the Stock Company would have the incentive to appropriately use the right to seek an injunction in contests for control such as hostile takeovers. Consequently, Note 2 indicates that this issue will be given further consideration.

In the case where a shareholder exercises the right to seek an injunction preventing the exercise of voting rights and the effects of the injunction arise as between the exercising shareholder and shareholder in violation of regulations, there is debate as to whether the effects also extend automatically to the Stock Company. It is necessary to consider further the procedures necessary for the effects of such an injunction to extend to the Stock Company in order to ensure the effectiveness of the injunction. Note 3 indicates that further consideration is required of this issue.

Note 4 concerns the method of calculating a quorum of the Shareholders Meeting in the case where a violator is prevented by an injunction from exercising voting rights. Under Article 309 (1) to (3) of the Companies Act, a quorum for resolutions of the Shareholders Meeting is determined on the basis of the number of votes of the shareholders who are entitled to exercise their votes, and if votes subject to an injunction are not included in the calculation of the quorum, the calculation shall be performed on the basis of the remaining votes only, and it may be possible for a shareholder or shareholders with only a minority of votes to make decisions concerning fundamental matters relating to the Stock Company. Consequently, further consideration is required of whether excessive influence can be exerted on decision-making concerning fundamental matters relating to the Stock Company. On the other hand, if the votes that are subject to an injunction are included in the calculation of the quorum, the minimum required number of votes may not be available, making it impossible to make decisions concerning important matters and impeding management of the Stock Company. With respect to this point, further consideration is needed concerning cases where a Purchase, etc. of a large

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volume of Share Certificates, etc. is made in violation of the Tender Offer regulations from the perspective of the extent of the effect of an injunction preventing the exercise of voting rights pursuant to the System. Accordingly, Note 4 indicates that further consideration of this point shall be made.

## **II. Grounds for Refusal of a Request for Inspection, etc., of Shareholder Registry, etc.**

1. Current law specifies as grounds for refusal of a request for inspection, etc. of the shareholder registry and registry of share options “The Requestor operates or engages in any business which is, in substance, in competition with the operations of such Stock Company” (Companies Act, Article 125(3)(iii) and Article 252(3)(iii)). It has been explained with respect to these grounds that this is because information relating to the Stock Company’s capital policies and so on can be determined from the shareholder registry.

It has been pointed out, however, that there are no reasonable grounds for refusing a request for inspection, etc. simply because the Requestor is, in substance, in competition with the Stock Company (see the June 12, 2008 decision of the Tokyo High Court, *Kinhan* No. 1295, p. 12), and most members of the Subcommittee are of the same opinion. Accordingly, Chapter II of the Interim Proposal calls for deletion of Article 125(3)(iii) and Article 252(3)(iii) of the Companies Act.

The concern was expressed within the Subcommittee that if these provisions are deleted, a Stock Company would not be able to refuse a request for inspection, etc. of the shareholder registry even in the case of abuse by a Requestor who is, in substance, in competition with the Stock Company. It is believed, however, that if it is determined that a request for inspection, etc. of the shareholder registry is abusive, the grounds for refusal specified in the items other than Article 125(3)(iii) and Article 252(3)(iii) of the Companies Act will apply. Therefore, these concerns do not support a need to maintain Article 125(3)(iii) and Article 252(3)(iii) of the Companies Act.

2. It was also suggested within the Subcommittee that the grounds for refusal specified in Article 125(3)(i) and (ii) and Article 252(3)(i) and (ii) of the Companies Act, i.e., the request is made “for a purpose other than for research on securing or exercising [the Requestor’s] rights” and “The Requestor made the request with the purpose of interfering with the execution of the operations of such Stock Company or prejudicing the common benefit of the shareholders,” may be interpreted in an overly broad manner, and as a result, the wording of these provisions should be reviewed.

Article 125(3) and Article 252(3) of the Companies Act were newly adopted for the purpose of clarifying typical grounds for refusal of a request for inspection, etc. of the shareholder registry, etc. Article 125(3)(i) and (ii) of the Companies Act are understood to clarify with respect to a request for inspection, etc. of the shareholder registry, etc. the fundamental principle found in judicial precedent that an exercise of shareholder rights must not be an abuse

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of rights (July 20, 2010 decision of the Tokyo District Court, *Kinhan* No. 1348, p. 14), and the scope of application of foregoing is determined in light of this purpose. There were concerns within the Subcommittee that a review of the grounds for refusal may lead to an increase in the burdens on Stock Companies relating to determinations of whether requests for inspection, etc. of the shareholder registry, etc. are abusive, and it is necessary to take these concerns into consideration when conducting a review of the grounds for refusal.

Accordingly, the note indicates that it is necessary to make a careful decision regarding the question of whether to review the wording of Article 125(3)(i) and (ii) and Article 252(3)(i) and (ii) of the Companies Act keeping the foregoing points in mind.

### **III. Other Matters**

#### **1. Contract for Subscription of the Total Number of Shares for Subscription when Shares for Subscription are Shares with Restriction on Transfer**

Article 204(2) of the Companies Act provides that in cases where Shares for Subscription are Shares with Restriction on Transfer, determination of persons to whom Shares for Subscription will be allotted and the number of Shares for Subscription to be allotted to those persons must be made by resolution of a Shareholders Meeting (or in the case of a Company with Board of Directors, the Board of Directors). This provision is based on an intent to expand the scope of rules concerning the approval of transfers of Shares with Restrictions on Transfer (the decision whether to approve such a transfer must be made by resolution of a Shareholders Meeting (in the case of a Company with a Board of Directors, a resolution of the Board of Directors) (Companies Act, Article 139 (1)) so that the rules cover subscription of Shares with Restrictions on Transfer.

Article 205 of the Companies Act provides that Article 203 and Article 204 do not apply in cases where a person who intends to subscribe for Shares for Subscription executes a contract for subscription for the total number of those shares. Thus, the text of Article 205 specifies that Article 204(2) does not apply, but the intent of that paragraph is applicable even in cases where an all shares subscription agreement is executed. Accordingly, even in cases where such a contract is executed, it is proper that decisions concerning matters relating to the allocation of Shares with Restriction on Transfer require a prior resolution of the Shareholders Meeting (in the case of a Company with a Board of Directors, a resolution of the Board of Directors).

Chapter III, 1 of the Interim Proposal provides that in cases where a person who intends to subscribe for Shares for Subscription executes a contract for subscription for the total number of those shares and the shares are Shares with Restrictions on Transfer, the Stock Company shall obtain prior approval by means of a special resolution of the Shareholders Meeting (in the case of a company with a Board of Directors, a resolution of the Board of Directors); provided, however, that this will not apply if there is an express provision otherwise in the Articles of Incorporation, as in the case of Article 204(2) of the Companies Act.

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Further, Article 243(2) of the Companies Act provides that in the case where Share Options for Subscription are Shares with Restriction on Transfer, determination of persons to whom Shares Options for Subscription will be allotted and the number of Share Options for Subscription to be allotted to those persons must be made by resolution of a Shareholders Meeting (or in the case of a Company with a Board of Directors, the Board of Directors). Article 244 provides that the provisions of Article 242 and Article 243 do not apply in cases where a person who intends to subscribe for Share Options for Subscription has executed a contract for subscription for the total number of those shares, and thus, pursuant to the text of Article 244, the provisions of Article 243(2) do not apply in this case. As in the case of Article 204(2), however, Article 243(2) is based on an intent to expand the scope of the rules concerning the approval of transfers of Share Options with Restrictions on Transfer (Companies Act, Article 265(1)) to cover subscription of Share Options with Restrictions on Transfer, and this intent applies even in cases where a contract for subscription for the total number of those shares has been executed. The note indicates that the same provision shall also be established for cases where a person who intends to subscribe for Share Options for Subscription has executed a contract for subscription for the total number of those shares and the Share Options are Share Options with Restrictions on Transfer.

## **2. Registration of the Scope of Audit by Company Auditors**

Article 2(ix) of the Companies Act defines a “Company with Auditors” to exclude a Stock Company whose Articles of Incorporation provide that the scope of the audit by its Auditor(s) shall be limited to audits related to accounting. Article 911(3)(xvii) of that Act provides that if the company is a Company with Auditors, a statement to that effect and the name(s) of the Auditors are recorded; a “Company with Auditors” in this case includes a Stock Company whose Articles of Incorporation include provisions limiting the scope of audits by the Auditors to accounting matters. As a result, in terms of recording, there is no distinction between Companies with Auditors specified in Article 2(ix) and Stock Companies with a provision in the Articles of Incorporation limiting the scope of audits by the Auditors to accounting matters.

There are differences, however, in the provisions of the Companies Act depending on whether a Stock Company has a provision in the Articles of Incorporation limiting the scope of audits by the Auditors to accounting matters, i.e., whether it is a “Company with Auditors” under Article 2(ix). For example, if a “Company with Auditors” under Article 2(ix) receives a demand to file an action pursuant to Article 847(1), the Auditors represent the Stock Company (Article 386(2)(i)), but if a Stock Company that is not a “Company with Auditors” under Article 2(ix) receives such a demand, the representative director represents the Stock Company (Article 349(4)).

In this way, because the provisions of the Companies Act can differ from depending on whether a company is a “Company with Auditors” pursuant to Article 2(ix), if there is a provision in the Articles of Incorporation limiting the scope of audits by the Company Auditors

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to accounting matters, it is proper that this shall be stated clearly in the registration. Accordingly, Chapter III, (2) of the Interim Proposal calls for such provisions of the Articles of Incorporation to be added to the matters to be registered.

### **3. Recording of Reserves in a Jinteki Split**

Article 792(ii) and Article 812(ii) of the Companies Act excludes the so-called “Jinteki” split—whereby a Splitting Company distributes surplus using as distributable assets only shares or equity interest in the Succeeding Company in an Absorption-type Company Split or the Company Incorporated through an Incorporation-type Company Split delivered as consideration for such Splitting Company on the Effective Date of a Company Split—from the scope of application of Part 2, Chapter 5, Section 6 of the Companies Act (restrictions on funds sources in Article 461 et seq.). Article 792(ii) and Article 812(ii) of the Companies Act are not exempt from application of Article 445(4), which requires the recording of reserves when paying dividends from surplus, and as a result, it is believed to be necessary to record reserves pursuant to this paragraph in the event of a jinteki split.

The requirement under Article 445(4) to record a certain amount of reserves when paying dividends from surplus, however, is intended to prepare for losses at a different time by reserving a certain amount of income. Accordingly, in a jinteki split that distributes surplus regardless of the Distributable Amount, there is no need to record reserves. Also, as indicated above, a jinteki split is exempt from provisions regarding sources of funds, and there is no reason to require only the recording of reserves.

Accordingly, Chapter III, 3 of the Interim Proposal eliminates the requirement to record reserves pursuant to Article 445(4) of the Companies Act when effecting a jinteki split where the Splitting Company distributes surplus using as distributable assets only the shares or equity interest of the Succeeding Company, etc., that the Splitting Company received as consideration for the Company Split.

### **4. Rules concerning the Total Number of Authorized Shares**

Article 37(3) of the Companies Act provides that the total number of shares issued at the time of incorporation of a Public Company may not be less than one fourth (1/4) the Total Number of Authorized Shares, and Article 113(3) provides that if a Public Company revises its Articles of Incorporation to increase the Total Number of Authorized Shares, the Total Number of Authorized Shares at the time that the revision of the Articles of Incorporation takes effect may not be more than four times the total number of issued shares. The intent of these provisions, which set forth the “four times” rule, is to limit dilution of the holdings of existing shareholders.

Article 814(1) of the Companies Act provides that Part 2, Chapter 1 (excluding certain provisions) does not apply to the establishment of a Stock Company Incorporated through

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Consolidation-type Merger, etc. (Stock Company Incorporated through Consolidation-type Merger, a Stock Company Incorporated through Incorporation-type Company Split, or a Wholly Owning Parent Company Incorporated through Share Transfer), and that the stipulations of Article 37(3) do not apply. Current law also has no provision concerning the four times rule in the case of revision of the Articles of Incorporation for a non-public Stock Company to become a Public Company.

In the cases of both the incorporation of a Stock Company and the non-public Stock Company that becomes a Public Company, the intent of the four times rule applies. Accordingly, Chapter III, 4 of the Interim Proposal extends application of the four times rule to these cases as well (see Part 1, III, 2(2) of the Interim Proposal).