1994 COMPANY LAW AMENDMENT REGARDING THE ACQUISITION BY A COMPANY OF ITS OWN SHARES AND CORPORATE GOVERNANCE IN JAPAN

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Contents

1. Introduction

The general company law system was introduced into Japan for the first time as a part of the first Japanese Commercial Code (JCC) of 1890 which was imported from Germany. The current Japanese company law in 1899 was also modelled on German company law.[1)]

Despite the drastic amendment to Japanese company law after the Second World War which was directed by the General Headquarters of the Allied Forces, no change at all was made to the provisions relating to the acquisition by a company of its own shares.

2. The Historical Background to the 1994 Amendment

2-1. The Restriction in General

Before the 1994 Amendment, the acquisition by a company of its own shares was, in principle, strictly restricted under Japanese company law. The main reasons for this restriction were as follows.

First, the interests of the company's creditors might be injured if the company was

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1) *See generally*, H. Oda, *Japanese Law* (Butterworths, 1992), 261; K. Yoshimoto, 1993 Company Law Amendment on the Supervisory System and Corporate Governance in Japan, 41 Osaka Univ. L. Rev. 23(1994).

permitted to purchase its own shares with its own funds. In a public limited company(plc), since the liability of the shareholders is limited to their contribution to the company (JCC art.200 para.1), company law requires a company to maintain assets which are more than the company's legal capital to protect its creditors (principle of keeping the company's assets more than its legal capital). For example, a company may distribute its assets as a dividend to its shareholders only after the amounts equal to its legal capital and reserves which are required to be maintained under company law are deducted from its net assets (JCC 290). A corollary to this is the principle of prohibition of repayment to the shareholders of the contribution. The purchase by a company of its own shares has, therefore, the same effect as the repayment by a company of the shareholders' contribution.

Second, there is a danger of breaching the principle of equal treatment of shareholders. When the company purchase its own shares from certain shareholders at a higher price than a fair price, it will prejudice the interests of the other remaining shareholders. And even if the company purchased its own shares at fair price, it would mean that shareholders in a closed company which does not trade on the stock exchange who sold their shares back to the company would have gained an advantage over other shareholders. On the other hand, the shareholders who sold their shares would be harmed if the company purchased their shares at a low price when the company has a good information for the company's future prospects (insider dealing).

Third, there is a danger of distorting the principle of control of the company by the shareholders. For example, when some shareholders try to make a hostile acquisition of the company, the directors could buy back a block of shares with company funds to reinforce their position or to skyrocket the share prices to make it difficult to make additional share purchases. In the former case, it would be difficult to identify the shares as having been acquired with company funds if they were purchased in the name of a nominee. In such a case, the directors would have acquired greater voting rights at the shareholders meeting without any contribution and risk sharing thus leading to a distortion of the principle of shareholders' control of the company.

Fourth, there is a danger of insider trading and manipulation of share prices. In contrast to the three former dangers, this is a danger concerned with the fair trading of a company's securities on the stock exchange and therefore relates to securities regulations and not to the company law in the strictest sense.

2-2. Cases Where a Company May Acquire Its Own Shares

In consideration of these dangers, the acquisition by a company of its own shares had been generally restricted under Japanese company law (JCC art.210 pre 1994 amendment). There were, however, some exceptions to this principle.

First, JCC art.210 provided for four exceptions. 1. A company may acquire its own shares to cancel such shares. In this case, there are two ways of cancelling shares(JCC 212). One is by decreasing the legal capital of the company. In order to do so, measures must be taken to protect the interests of the creditors of the company (JCC art.376 para.2 and 3, art.100). The other way is the cancellation of shares through company profits which are distributable to shareholders in accordance with the provision in the company's articles which authorize the acquisition. The latter way doesn't result in the decrease of the legal capital so that it is unnecessary to require measures to protect the creditors. 2. A company may acquire its own shares as the result of a merger with another company or an acquisition of the whole business of an another company which already holds shares in that company. As either a merger or an acquisition of the whole business results in the transfer of the entire assets and debts of the acquired company, it is inevitable for the acquiring company to acquire its own shares if the acquired company holds shares of the acquiring company. 3. A company may acquire its own shares in the course of enforcing its rights. When the company enforces a compulsory execution as a creditor and the debtor has no assets other than the shares of the company, it has no option except to acquire its own shares. Also, it is beneficial to the company to hold its own shares as a security in case the debtor has no assets other than shares of the company. 4. Where certain resolutions are made at the general meeting (*ex.* merger, the transfer of the whole business of the company, change of the articles of the company to restrict the free transferability of shares or the transformation of a company from a plc to a private limited liability company), the company is obliged to acquire its own shares which are held by the dissenting shareholders to such resolutions (the appraisal right of shareholders). In such cases, if the dissenting shareholders request the acquisition, the company must buy its own shares at fair price which the shares would have had if there had been no resolution (JCC art.245-2, 349.1, 408-3 and Act to Private Limited Liability Company art.64).

Secondly, both the courts and scholarly theory recognizes that a company may acquire its own shares where none of the above-mentioned dangers exist because prohibiting a company from purchasing its own shares is not an essential part of company regulation by law, but a policy measure. Hence, a company can acquire its own shares without compensation. Furthermore, a company can acquire its own shares in its own name, if this is done on behalf of others as trustee or broker.

2-3. Arguments for Relaxation of Regulation

For many years, strong arguments have been made for the relaxation of regulations restricting a company from purchasing its own shares. In particular, corporate management groups have long insisted that the regulations interfere with the smooth and flexible management of the company necessary to cope with changing economic circumstances. In the late 1960's, the Japanese government decided to deregulate Japanese stock market in order to allow foreign investors to acquire shares in Japanese companies. In response to this deregulation, Japanese companies began cross-purchasing shares to prevent foreign investors from taking corporate control of Japanese companies and this practice of cross holding of shares has become entrenched that it now constitutes one of the characteristics of the Japanese companies system. At present, over 70 percent of outstanding shares of all listed companies are held by other companies. During this same period, the company management demanded that the government relax regulations on the acquisition by a company of its own shares but received little supports from legal scholars.

Recently, there have been on-going negotiations between the Japanese and American governments regarding comprehensive solution to the economic friction between Japan and the US. During these negotiations, the American representatives argued the necessity of changing the Japanese *keiretsu* system in order to promote foreign entry into Japanese markets. To this end, it was considered that deregulating strict regulations concerning the acquisition by a company of its own shares would be effective in demolishing the cross shareholding practice which is the mainstay of the *keiretsu* system in Japan. Gradually, the arguments in favor of deregulation of restrictions on the acquisition by a company of its own shares have become the majority opinion among legal scholars because it is considered unnecessary to prohibit the acquisitions by a company of its own shares as long as there is no danger of abuse. Also, company laws within the European Communities are generally more liberal than in Japan on this matter. Considering these practical, doctrinal and comparative reasons, the Japanese government decided to amend the Japanese Commercial Code to relax regulations on the acquisition by a company of its own shares. The amendment bill was passed by the Diet in June 1994 and came into force on 1 October 1994.

3. Substance of the 1994 Amendment

The amended company law adds four other cases in which a company may purchase its own shares. 1.Where there is a legitimate reason, a company may acquire its own shares for the purpose of transferring such shares to its employees (JCC art.210-2 para.1). According to government officials, such legitimate reasons exist where the shares acquired will be transferred to an employee shareownership scheme or to employees who have been employed for a certain length of time. 2. A company may acquire its own shares for the purpose of cancelling the shares even where there is no provision in the company's articles authorizing such an acquisition (JCC art.212-2 para.1). 3. A company may acquire its own shares when a shareholder in a company which has a provision in its articles stipulating that share transfers require the approval of the board of directors, requests the approval of a share transfer to a third person and there is no person to acquire these shares instead of that third person other than the company (JCC art.210 para.5). 4. A company may acquire its own shares when shareholders in closed company mentioned above, wish to sell their shares to the company within one year from the succession of shares (JCC art.210-3 para.1).

There are some requirements for these acquisitions by way of precautions against abuse. It is a procedural requirement that the general meeting of shareholders must approve the acquisition itself (case 3 and 4) or the authorization of the acquisition which limits the numbers of shares the board of directors can purchase within one year (case 1 and 2). In the case of listed companies and companies whose shares are traded in the over-the-counter market, a company must purchase shares in the stock market (case 1 and 2) or by way of a takeover bid (case 2). The acquisition will necessarily be made through personal negotiations in the case of unlisted companies (in all cases). Hence, in order to secure equal treatment among shareholders, other shareholders in unlisted companies must be given the opportunity to propose to sell their shares to the company under the same conditions (case 1 and 2).

It is a substantial requirement that a company may purchase its own shares only from distributable profits (JCC arts.204-3-2 para.5, 210-2 para.3, 210-3 para.2 and 212-2 para.3). This requirement comes from the principle of keeping the level of the company's assets above the legal capital of the company. When the company's assets are less than the legal capital at the end of the business year, the directors are responsible to the sum of the margin between the legal capital and the company's assets (JCC arts.210-4 and 212-2 para.5 and 6). However, the directors are exempt from these responsibilities if they can prove that they have not been negligent in their conduct. Furthermore, a company can buy back up to 3 percent (case 1) or 20 percent of its all outstanding shares (total in cases 3 and 4).

4. Some Remarks from a Comparative Standpoint

4-1. Comparison between Some Company Laws

a. In the US, most state corporation laws allow the corporate board to acquire its own shares out of surplus freely. When a company acquires its own shares, these shares purchased are either cancelled or treated as treasury shares which have the same position as the authorized but not issued shares.[2)]

On the other hand, company laws within the EC generally restrict the acquisition by a company of its own shares, but provide for exceptions. For example, the Second Council Directive on EC company law[3)] provides that a company can acquire its own shares where the general meeting authorizes the terms and condition of such acquisition and the nominal value or, in the absence thereof, the accountable par of the acquired shares, including shares previously acquired by the company and held by it may not exceed 10 percent of the subscribed capital (art.19 para.1a and b). The laws of a Member State may provide for derogations from the first sentence of paragraph 1a where the acquisition of a company's own shares is necessary to prevent serious and imminent harm to the company (art.19 para.2). Member States may decide not to apply the first sentence of paragraph 1a to shares acquired by the company for distribution to that company's employees or to the employees of an associate company (art.19 para.3).

In Britain, the Companies Act 1981 which implemented the Second EC Company Law Directive and now is consolidated in the Companies Act 1985 permitted a company to purchase its own shares in certain cases. The Companies Act 1985 permits the acquisition by a company of its own shares, *inter alia*, when authorized to do so by its articles (s.162(1)). Shares may not be acquired unless they are fully paid up (ss.162(2) and 159(3)). A purchase may be either a "market purchase" or an "off-market purchase" (s.163). A company must not make a market purchase of its own shares unless the purchase has first been authorized by the company in general meeting (s.166). The company may only make an off-market purchase of its own shares in pursuance of a contract which must be authorized by a special resolution of the company before the contract is entered into (s.164). The purchase may only be made out of the distributable profits of the company or out of the proceeds of a fresh issue of shares made for the purpose of the purchase (ss.160 and 162(2)). Shares acquired shall be treated as cancelled and the amount of the company's issued share capital shall be diminished by the nominal value of those shares accordingly, but the purchase of

2) H.G. Henn and J.R. Alexander, *Laws of Corporations and Other Business Enterprises*, 3rd ed.(West Pub., 1983), 936 et seq.; B. Black, *Corporate Dividends and Stock Repurchases* (Clark Boardman, 1990), 2-22.

3) 77/91/EEC. Second Council Directive of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent. OJ L26/1.

shares by a company is not to be taken as reducing the amount of the company's authorized share capital (ss.160(4) and 162(2)). Where shares of a company are purchased out of the company's profits, the amount by which the company's issued share capital is diminished in accordance with section 160(4) on cancellation of the shares purchased shall be transferred to a reserve, called "the capital redemption reserve" (s.170).

In Germany, the Second EC Company Law Directive was implemented by the 1978 amendment to the Aktiengesetz. A company may acquire its own shares, *inter alia*, when a: there is a need for the company to acquire its own shares to prevent serious and imminent harm to itself (art.71 para.1(1)), b: a company intends to transfer its shares to its employees or employees of an affiliated enterprises (art.71 para.1(2)), and c: the general meeting authorizes the purchase to cancel shares in accordance with provisions relating to the redemption of the legal capital (art.71 para.1(6)). The acquisition of shares in cases a and b must be made in accordance with requirements as follows. A company may not purchase its own shares if the nominal value of shares to be purchased, including shares previously acquired and held by it, exceeds 10 percent of its legal capital (art.71 para.2, 1st sentence). The acquisition of shares must be made with the distributable profits (art.71 para.2, 2nd sentence). The acquisition of shares may not be made unless they are fully paid up (art.71 para.2, 3rd sentence). A company must make the undistributable reserve equal to the value of the shares acquired and held by it (art.272 para.4 HGB).

In France, the Second EC Company Law Directive was implemented by the amendment to the code des sociétés in 1981[4]. A company may purchase its own shares, *inter alia*, when a: the general meeting authorizes the purchase to adjust its market price (art.217-2 para.1), b: a company intends to transfer its own shares to its employees (art.217-1), and c: there is a need to acquire its own shares to prevent the company being declared void (art.365). The acquisition of shares in cases a and b must be made in accordance with requirements as follows. A company may not purchase its own shares if the number of shares to be purchased together with shares previously acquired and held by it exceeds 10 percent of the total of outstanding shares and of outstanding shares of a certain class (art.217-3 para.1). The shares which are purchased must be fully paid up at the time of purchase (art.217-3 para.1, 2nd sentence). The acquisition must be made out of the distributable profits (art.217-3 para.2). A company must fix the undistributable reserve at an amount equal to the value of shares held by it (art.217-3 para.3).

4) Loi no 81-1162 du 30 déc. 1981 which was further amended thereafter.

b. Generally speaking, the 1994 Japanese Company Law Amendment which extends the situations in which a company may purchase its own shares followed the EC company law model; that is the amended law restricts in general the acquisition by a company of its own shares but provides for certain exceptions. Thus, the new law allows the company to acquire its own shares for transfer to company employees. It also requires the authorization of the acquisition by the general meeting and limits the amount of the purchase to the amount of the distributable profits and the number of shares to be bought, including those shares previously acquired and held by it, to a certain percentage of the outstanding shares.

On the other hand, the 1994 Japanese Company Law Amendment does not permit the acquisition by a company of its own shares where the purchase is considered to be necessary to prevent serious and imminent harm to the company itself. This exception was not included as it was thought that such an exception would create a uncertainty in interpretation and that there is a danger of abuse of this power by the management.

4-2. Impacts of the Amended Company Law on Corporate Governance

It would be worthwhile to note that the 1994 Japanese Company Law Amendment will have an impact on corporate governance of Japanese company in two ways.

a. First, the amended law permits the acquisition by a company of its own shares in order to transfer such shares to company employees where there is a legitimate reason. According to the traditional view, the company is owned by shareholders who alone bear the business risks, and the directors must use their powers for the best interests of the shareholders[5]. On the other hand, employees are not members of the company, but simply parties to a labor contract with the company. Thus, according to this view, the interests of employees need not be protected under company law. The board of directors may respect employees' interests provided that it will foster the interests of the company and shareholders.

In reality, however, one cannot completely dismiss the notion that a company consists of employees as well as shareholders. In various EC member countries it has been recognized that employees are indispensable members of a company and even in the US they are often called stakeholders in the company[6]. For example, in some EC

5) *See,* American case, Dodge v. Ford Motor Co.,204 Mich. 459, 170 N.W. 668.

6) *See,* Symposium: Corporate Malaise-Stakeholder Statutes: Cause or Cure?, 21 Stetson L. Rev. 1(1991). Recently, some state anti takeover statutes provide that the directors facing a tender offer may take into consideration employees' interests in discharging their duties. L. E. Mitchell and L. D. Solomon, *Corporate Finance and Governance, Cases, Materials and Problems for Advanced Course in Corporations* (Carolina Academic Press, 1992), 890.

countries there are certain types of schemes allowing employees to participate in the management of the company (co-determination).[7] British company law stipulates that the matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its members (s.309(1))[8]. Hence, it may be said that the company laws in many countries recognize that employees' interests should be protected equally with the interests of the shareholders. Japanese company law did not have any provision dealing with employees' interests before this amendment. However, the Fukui district court acknowledged the employees' interests when it held that financial assistance to the employees shareownership scheme was lawful and did not infringe the prohibition on unauthorized payment to shareholders (art.294-2)[9]. It is possible to interpret this amendment as recognizing either that the employees' interests should be protected under company law, or that the company law still protects only the shareholders' interests because a share acquisition for the purpose of transfer such shares to employees must be approved by a resolution at a general meeting.

b. Second, the amended company law permits the acquisition by a company of its own shares for cancelling shares. As mentioned before, over 70 percent of all outstanding shares of companies listed on the stock exchange are held by other companies in Japan. This practice of cross shareholding has been criticized as supporting the Japanese *keiretsu* system which is one of barriers to foreign business trying to enter Japanese markets and hence such excessive cross shareholding should be reduced[10]. On the other hand, since share prices are at low level after the crash of the "bubble economy", company managers want to cancel their company's shares and to decrease the number of outstanding shares to keep share prices high by buying their shares with the company funds. If it is possible for listed companies to mutually buy back shares held by another company it may not be necessary to finance the purchase from company funds because money paid by A company to B company when A company purchases its own shares from B company is to be paid by B company to A company

7) *See,* K.J.Hopt, New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards, 82 Mich. L. Rev. 1338 (1984); J.E.Parkinson, *Corporate Power and Responsibility* (Clarendon Press, 1993), 402 et seq.

8) But it is pointed out that this obligation is imperfect. See, R. R. Pennington, *Pennnington's Company Law,* 6th ed.(Butterworths, 1990), 584.

9) *See,* the Fukui district court case of 29.3.1985 (*kinyu-shojihanrei* no.720 p.40).

10) For the Japanese *keiretsu* system in terms of corporate governance, *see,* R.J.Gilson and M.J.Roe, Understanding the Japanese keiretsu: Overlaps between Corporate Governance and Industrial Organization, 102 Yale L.J. 871(1993).

in return when B company purchases its own shares from A company[11].

However, in the case of listed companies, the amended company law requires the acquisition to be made by way of either a market purchase or a takeover bid. This requirement was considered necessary to secure equal treatment of shareholders. In Japan, there is a special type of securities dealing on the stock market called "cross dealing" where a specific shareholder sell his shares through the stock market to a specific person under certain conditions in pursuance of an agreement made in advance between the two parties. If a company can buy its own shares through this kind of special dealing, it would be helpful in reducing the cross shareholdings among Japanese listed companies. At the moment, however, it is arguable as to whether this type of dealing comes within the "market purchase" requirement of the amended company law.

11) This is exactly the reverse transaction of cross subscription of new issued shares.