



Title	1993 COMPANY LAW AMENDMENT ON THE SUPERVISORY SYSTEM AND CORPORATE GOVERNANCE IN JAPAN
Author(s)	Yoshimoto, Ken-ichi
Citation	Osaka University Law Review. 1994, 41, p. 23-32
Version Type	VoR
URL	<a href="https://hdl.handle.net/11094/11764">https://hdl.handle.net/11094/11764</a>
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# 1993 Company Law Amendment on the Supervisory System and Corporate Governance in Japan

*Ken-ichi Yoshimoto\**

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### 1. Introduction

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

After the Second World War, the Japanese company law was amended drastically in accordance with directives of General Headquarters of the Allied Forces (GHQ)<sup>2)</sup>. The amended company law was based mainly on US corporate law<sup>3)</sup>. Consequently, it has been often said that Japanese company law is like a grafted tree. In fact, there are many problems not only in doctrinal but also functional aspects of our company law.

The supervisory system of a public limited company (*kabushiki-kaisha*, plc) is one of the clearest cases of this kind<sup>4)</sup>. This paper will examine the objectives and

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\* Associate Professor of Commercial Law, Faculty of Law, Osaka University, Japan. The author would like to thank Ms. Michelle Tan for her editorial help.

- 1) The first Japanese Commercial Code (JCC) was drafted by the German lawyer Hermann Roesler in 1890 but its enforcement was suspended until 1893 as a result of a postponement of the introduction of the first Japanese Civil Code which was criticized for its liberal character. In 1899, the current Japanese Commercial Code revised the first Commercial Code.
- 2) See generally, H. Oda, *Japanese Law* (Butterworths, 1992), p.261.
- 3) K. Yamaguchi and N. Tozuka, The situation of the Corporation Management in Japanese Corporate System, 18 Osaka Univ.L.Rev.1, 3(1971).
- 4) There are four types of company in Japan. These are: a public limited company, a private limited company (*yūgen-kaisha*), a partnership company (*gōmei-kaisha*) and a limited partnership company (*gōshi-kaisha*).

effectiveness of the 1993 amendment regarding the supervisory system of a public limited company.

## 2. The Historical Background of the 1993 Amendment

### 2-1. The 1950 Amendment<sup>5)</sup>

Before the 1950 company law amendment, Japanese company law required a plc to have a two-tier administration structure as in German company law (Aktiengesetz). The management organ (*torishimariyaku*) managed the business of the company and the supervisory organ (*kansayaku*) monitored and reviewed the legality and performance of the management organ's activities. Members of the supervisory organ could not be members of the management organ at the same time, but unlike German law, the general meeting of shareholders elected both members of the management and the supervisory organs. It was therefore difficult for the supervisory organ to control the management organ because it did not have the power to elect or dismiss management members who were armed with proxies to vote from their large shareholders.

The 1950 amendment introduced an American style board of directors system (*torishimariyakukai*) into a plc. The general meeting of shareholders appoints at least three directors (JCC Art.255) who form the board of directors. The board of directors elects one or several representative directors (*daihyo-torishimariyaku*) who have the authority to direct all the business of their company and to represent it to a third party (JCC Art.261 para.1)<sup>6)</sup>. The board also oversees the activities of the representative directors and members of the board.

Thus, it was felt that there was no need to give the supervisory organ a supervisory power over the conduct of the directors in addition to the monitoring function of the board of directors. Although there were some arguments for the abolishment of the supervisory organ, finally it was decided that it should continue to exist with a limited

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Unlike under German company law, a partnership company and a limited partnership company also have a legal personality as an incorporated body. *See, Doing Business in Japan*, vol.4, §1.03 (Matthew Bender, 1981). They are all defined under JCC and the Private Limited Company Act (Law No.74, 1938) as an association established for the purpose of conducting commercial transactions as a business (JCC Art.52 and PLCA Arts.1, 2). There are about one million and three hundred thousand public limited companies of which at most 2200 are listed companies, as well as over one million and six hundred thousand private limited companies in Japan. Almost all these companies are small or medium sized. The main reasons for the large number of companies are tax privileges and advantages in recruiting employees. Oda, *supra*. n.2 at p.265.

5) Law No.167, 1950.  
6) As to the historical perspective of a legal position of the representative directors, *see*, K. Yamaguchi, Legal Position of Managing Directors in Japanese Company Law—Historical Perspective—, 26 Osaka Univ. L. Rev.9 (1979).

power as regards auditing company's accounts<sup>7)</sup>.

Unfortunately, this mixed system of German and American law did not work well. In Japan, the functions of the directors and executive officers are not clearly distinguished as in American corporate law and practice. Most directors are also executive members such as a president, a vice-president, a senior executive director (*senmutorishimariyaku*) and a junior executive director (*jōmu-torishimariyaku*), or are worker-officers who have a legal relationship with the company as an employee as well. There are few non-executive or outside members on the board<sup>8)</sup>. Accordingly, most directors are subject and subordinate to the direction of the representative directors, the president in particular, for their daily decision-making regarding business, and do not have enough independence from them to supervise and control the latter effectively<sup>9)</sup>.

## 2-2. The 1974 Amendment<sup>10)</sup>

In 1974, the company law regarding the plc was reformed and the Act Providing an Exception to the Commercial Code for the Supervisory System of a PLC (AECS) came into effect. The amended company law gave a supervisory power to the supervisory organ again in order to create an effective control over the board of directors (JCC Art.274 para.1)<sup>11)</sup>. AECS laid down a compulsory auditing system by a certified public accountant (CPA) or an accounting firm for large companies with a stated capital of ¥1 billion or more which included most listed companies<sup>12)</sup>.

In a large plc, the auditing responsibility was firstly entrusted to a CPA or an accounting firm and it was expected that the supervisory organ should concentrate its duties on the review and control of the conduct of the directors. As mentioned before, however, the board of directors still had a monitoring power over the representative directors and other individual members of the board. Hence, there seemed to be a duplication of two supervisory functions in the administration of a plc and a need to harmonize these two supervisory functions with each other. According to the majority of legal academics, the supervisory organ should check the legality of the business conduct of the directors, whereas the board of directors should supervise the

7) Yamaguchi and Tozuka, *supra*. n.3 at p.3.

8) Oda, *supra*. n.2 at p.285.

9) Yamaguchi and Tozuka, *supra*. n.3 at p.15.

10) Law Nos. 21 & 22, 1974.

11) By the Act Providing an Exception, the supervisory organ of a plc with a stated capital of ¥100 million or less has only an auditing power regarding the company's accounting matters. AECS Arts.22, 25.

12) Oda, *supra*. n.2 at p.262-63, 292.

reasonableness and appropriateness of the conduct by the representative directors and other executive members<sup>13)</sup>.

It is clear from the above, that Japanese company law is unique in its approach to the supervisory system and corporate governance of a plc. As will be discussed later, it may be understandable that Japanese company law divides and distributes one supervisory function into two organs in a plc.

### 2-3. The 1981 Amendment<sup>14)</sup>

In the 1981 amendment of the Act Providing an Exception to the Commercial Code for the Supervisory System of a PLC, every large plc with a stated capital of ¥500 million or more or with a liability of ¥20 billion or more, was required to have at least two members and one full-time member in the supervisory organ. It was intended by this amendment to reinforce the supervisory power of that organ by strengthening its monitoring ability<sup>15)</sup>.

Despite these legislative efforts, neither the supervisory organ nor the board of directors were able to supervise and control the representative directors effectively. There were several notorious cases where some leading companies in banking and securities trading fields whose names have worldwide reputations were severely criticized for their misconduct and a failure of these two organs to carry out their functions respectively in late 80's, after the crash of the so-called bubble economy. It was thought this was a result of dependence by members of the supervisory organ and the board of directors on the representative directors. They are dependent on the latter for promotion up the hierarchical company organization because candidates for new members of the board and the supervisory organ are almost always decided and submitted to the board of directors by the representative directors. In addition, their remunerations are actually decided by the representative directors<sup>16)</sup>. Thus, the next

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13) This is still a matter of dispute among many academics and practitioners.

14) Law No.74, 1981.

15) Oda, *supra*. n.2 at p.263, 292.

16) In Japanese company law, it is the responsibility of the board of directors to draft and submit a bill of resolution to elect members of the supervisory organ and the board of directors at the general meeting. In exceptional cases, one or several shareholders in concert having at least 1 percent of the outstanding shares can propose their own bill to the general meeting (JCC Art.233-2). Remunerations of members of the supervisory organ and the board of directors must be decided in the company's statute (articles) or by the shareholders resolution in general meeting (JCC Art.269, 279). However, it is a usual custom in Japanese company to resolve at the shareholders meeting to entrust the supervisory organ and the board of directors respectively the power to decide remunerations of each member of these organs within the sum decided by the shareholders resolution. And in most circumstances, the board of directors decides to entrust the power

step in securing the functions of supervisory system was to assure the independence of the members of the supervisory organ from the representative directors.

### 3. Substance of the 1993 Amendment<sup>17)</sup>

After the 1981 amendment, a preparatory work on the next company law amendment was initiated by the Ministry of Justice. This work was intended to cover all the entire field of the company law but some urgent matters obliged the government to change its mind and to amend the company law partially in 1990<sup>18)</sup>.

After the 1990 amendment, the work on the revision of the company law continued. This work included the strengthening of shareholders' rights and powers and the ensuring the independence of the supervisory organ. At the time, there were on-going negotiation talks between the Japanese and American governments relating to the improvement of the trade imbalance between Japan and the US (Structural Impediment Initiative). During these negotiations, the American government pressured Japan to, *inter alia*, amend Japanese company law in order to protect shareholders interests. It was argued by the American representatives that it is necessary to promote the shareholders derivative suit which was introduced from US corporation law and seldom used successfully in Japan and to require a plc to have an outside director. The Japanese government promised to amend its company law in order to alleviate restrictions on the shareholders derivative suit, but argued it would be preferable to require an outside member in the supervisory organ, which US corporate law doesn't have, rather than in the board of directors. The amendment bill was drafted quickly and passed the Diet in June 1993.

#### 3-1. The amended provision which applies to all plcs

It is provided that the term of members of the supervisory organ is for three years (JCC Art.273 para.1). Before this amendment, this term was for two years. It is expected that this extension of the term will help to strengthen the independence of the members of the supervisory organ and to allow them time to gain a thorough knowledge of company's business affairs.

#### 3-2. Amended provisions which apply to large plcs

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to decide their remunerations to a representative director (the president). This practice was affirmed by our case law. *See*, the Supreme Court case of 22.2.1983 (hanrei-jihō, no. 1076, p.140).

17) Law No.62, 1993.

18) Law No.64, 1990. This amendment did not relate to the supervisory system of a plc.

a. Firstly, every large plc is required to have at least three supervisory members (AECS Art.18 para.1). This is because they constitute a supervisory board (AECS Art.18-2 para.1). The increase in the statutory minimum number and the creation of the supervisory board is intended to be an effective method for allowing members to maintain their independence from the representative directors. Another aim of the creation of the supervisory board is to make it possible to divide the monitoring work and responsibility of the supervisory board among members and to make a systematic supervisory organization. In a large plc in particular, since a company's business affairs covers a very wide range and is extremely complex, it is hardly possible for a single supervisory member to cover all these fields. Many large companies already have a voluntary supervisory board and divide their tasks among the supervisory members. This latest amendment has thus ratified these practices.

b. Secondly, a large plc must have at least one outside member on its supervisory board (AECS Art.18 para.1). The outside member must be a person who has not been a director, manager (*shihainin*) and employee of the company or any subsidiaries of the company for a period of at least five years before his/her appointment as a supervisory member.

In Japan, the majority of new members of the supervisory organ are elected from the former directors who have completed their term of office as a director. Consequently, there are problems of self-supervising<sup>19)</sup> and members' dependence on the representative directors who directed the company's business during the members' period of office as a director and actually decided their membership of the supervisory board. This amendment requires an outside member who has not been connected in any way with the company business affairs as an insider for at least five years before the appointment, thus it will help to reinforce the independence of the supervisory board. Although it would be better to prohibit anyone who was once an insider from becoming a supervisory member, it was thought that this would be too strict to find appropriate persons for a supervisory member.

#### 4. Some Comparative Remarks to EC company law

As mentioned above, the supervisory system in a plc has been a vital issue in

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19) Members of the supervisory organ often review their own conduct retrospectively after becoming a member of the organ. The Supreme Court has held that the supervisory acts by such a member of the supervisory organ are not a violation of the provision which prohibits a supervisory member to be a director (JCC Art.276). *See*, the Supreme Court case of 21.4.1987 (*shōjihōmu*, no.1110, p.79).

Japanese company law for many years, and remains so<sup>20)</sup>. Why doesn't it function well despite numerous amendments to the law? The answer to this question seems to be rather simple. It is because company law amendments have failed to create and maintain the independence of supervisory members from the representative directors.

In Japan, it is not uncommon for the representative directors to climb up the ladder of personnel positions in the organizational hierarchy of the company. Most directors and supervisory members were also former full-time employees<sup>21)</sup>. For many directors and supervisory members, the representative directors might have once been their boss and the latter have assisted their promotion to upper personnel positions<sup>22)</sup>. In addition, the representative directors usually have the power to decide membership of the supervisory organ and their remunerations. In these circumstances, they were once subordinates of the representative directors and hence it is hardly possible for them to actively supervise the conduct of the representative directors<sup>23)</sup>.

On this matter, EC company law harmonization presents very useful materials for us to study comparatively in order to plan a better supervisory system and corporate governance structure<sup>24)</sup>. Firstly, the Second Amendment to the Proposal for a Fifth Company Law Directive issued by the EC commission in 1991<sup>25)</sup> requires member states to provide that the company shall be organized according to a two-tier system (management organ and supervisory organ), but allows them to permit the company to have a choice between a two-tier system and a one-tier system (administrative organ)(Art.2)<sup>26)</sup>. Under this proposal, the supervisory function is assigned to a super-

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- 20) In Japan, the general meeting of shareholders does not have enough power and incentive to monitor the management of the company as in many other countries. Recently, however, it is often pointed out that Japanese cross-shareholding and keiretsu among financial and industrial companies provides an efficient monitoring system on the company's management. *See e.g.*, R.J. Gilson and M.J. Roe, Understanding the Japanese Keiretsu: Overlaps between Corporate Governance and Industrial Organization, 102 Yale L.J. 871(1993).
- 21) Oda, *supra*. n.2 at p.285. *See also*, M.J. Roe, Some Difference in Corporate Structure in Germany, Japan, and the United States, 102 Yale L.J. 1927, 1943 (1993).
- 22) Yamaguchi and Tozuka, *supra*. n.3 at p.15.
- 23) The so-called management control has been realized but in a different way in Japan from other countries. It has been said that the seniority rule applies evenly to the corporate managers as well as the manual workers. *See*, Yamaguchi and Tozuka, *supra*. n.3 at p.4.
- 24) For a comparative study of the supervision of company's management in the EC and the US, *see*, A. Conard, The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law, 82 Mich. L. Rev. 1459 (1984).
- 25) OJ C7/04, 11.1.1991.
- 26) This provision was not amended by the third amendment to the proposal for a fifth company law directive. *See*, OJ C321/09, 12.12.1991.

visory organ in a two-tier system on the one hand, and to non-executive members of an administrative organ in a one-tier system on the other hand. In each case there is no problem of overlapping of supervisory functions among the company's organs as in Japanese company law. More importantly, an organ or members which exercise a supervisory power have the authority to appoint members of the management organ or executive members of the administrative organ in each system. Consequently, the supervisory organ or non-executive members can effectively control the activities of the management organ or executive members of the administrative organ by this power of appointment.

Secondly, the amended proposal for a Council Regulation on the Statute for a European Company<sup>27)</sup> provides that the statute of the European Company (SE) shall organize the structure of the SE either according to a two-tier system (management board and supervisory board) or according to a one-tier system (administrative board). The proposal further allows member states to require that SEs having their registered office in its territory adopt either the two-tier or the one-tier system (Art.61 para.1). The members of the management board shall be appointed and removed by the supervisory board in the two-tier system (Art.62 para.2), but members of the administrative board shall be appointed and removed by the general meeting in the one-tier system (Art.66 para.3). In the latter case however, it is unclear that the non-executive members of the administrative organ shall supervise the executive members of that organ, because it is not mandatorily required that members of the administrative organ shall be divided into executive and non-executive members.

Thus, it is noteworthy from the above-mentioned that as a general organizational principle, it is necessary for the supervisory organ to have the power to appoint management members in order to effectively carry out its supervisory function in corporate governance structure. This is the only way for supervisory members to effectively control the activities of the management members.

It is true that the board of directors has both the power of appointment of the representative directors and the power of supervision in Japanese company law. Nevertheless, most directors are executive members or worker-officers as mentioned before. It may be said that the supervision essentially means the independent review from outside. Consequently, the directors' executive or worker function appears to be inconsistent with their monitoring position over the activities of the representative directors. On the other hand, it is the supervisory organ that is expected to exercise the power of supervision from the outside standpoint in Japanese company law. But it

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27) OJ C176/01, 8.7.1991.

does not have the power of appointment of the representative directors.

Hence it is a special feature of our company law relating to the supervisory system and corporate governance that the supervisory function and the power of appointment which should accompany it necessarily are divided and distributed to different organs of the company. This not only causes problems of duplication of supervisory function between the board of directors and the supervisory organ, but also results in neither organ working effectively. Therefore, the next amendment to the Japanese company law regarding the supervisory system might be aimed at securing the power of appointment of the representative directors by the supervisory organ.

