Outside help

Taro Tsunoda and Tsunemichi Nakano of Anderson Mori & Tomotsune describes proposed amendments to Japanese law covering the mandatory appointment of external directors

On December 14 2011, the Civil Affairs Bureau of the Ministry of Justice of Japan released proposals for a number of important amendments to the Companies Act. If enacted, the amendments would likely affect businesses in Japan considerably. The Ministry has invited the public to review the Intermediate Draft of Amendment to the Companies Act and submit its comments for consideration.

Among the amendments proposed in the Draft, this article focuses on the proposals regarding the mandatory appointment of external directors which will have significant practical implications.

Over the past few years, the corporate governance of Japanese companies has drawn enormous attention from domestic and overseas investors. It has also been the topic of examination and debate among scholars and practitioners, primarily due to the attention brought by media reports on misconduct of directors and officers, such as accounting fraud and embezzlement of the companies' funds.

One of the main reasons for such misconduct is said to be the malfunction of the monitoring system provided by the board of directors. Although the current Companies Act does provide certain measures that are designed to ensure the proper monitoring of the management, it has become apparent that these have not been functioning well. One such measure is the appointment of a corporate auditor (or board of corporate auditors). Since corporate auditors do not have any voting rights in board meetings under the current Companies Act, however, the effectiveness of the supervision of corporate auditors has been questioned. Another measure contained in the Companies Act relates to a governance system referred to as a "company with committees". This is designed to separate the management and supervisory functions of the company: the management is conducted by executive officers while the supervision is carried out by a board of directors and three committees, including an audit committee, compensation committee and appointment committee, each composed of directors. While this system is designed to be, and indeed is, capable of providing efficient and comprehensive supervisory functions of a company, it has not been widely adopted in Japan, primarily due to the operational and financial costs involved in establishing three committees.

For these reasons, the issue of strengthening the supervisory functions of the board of directors has been an important point on the agenda for corporate law reform in Japan over the past few years. Especially due to the traditional tendency of the boards of Japanese companies to appoint internal members (such as employees of the company or directors of the parent company) as their directors,

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the requirement of mandatory appointment of external directors has been considered to be one of the most effective measures to strengthen the supervisory functions of Japanese companies, and thus has become one of the proposed amendments to the Companies Act.

Different approaches

Under the Companies Act, an 'external director' is defined as a director of a joint-stock company who is not, and has never previously been, an executive director (a representative director, a director authorised by the board to carry out the operations of the company, or a director who has previously carried out such operations), an executive officer, general manager or any other type of employee of the company or any of its subsidiaries.

There has been criticism that these requirements are not strict enough to ensure the independence of the external director from the company and its management, since the directors and employees of a company's parent company or of important business partners of the company may still serve as an external director, and these individuals may not be fully independent from the company and/or its management.

At the same time, the Companies Act may be considered to be too rigid, as it does not provide a minimum period of time during which a person must have been unrelated to the company to qualify as an external director.

In December 2009, the Tokyo Stock Exchange (TSE) amended its listing rules. One of the purposes of the amendments was to strengthen the supervisory functions of TSE-listed companies. The new rules require TSE-listed companies to have at least one 'independent executive'. An independent executive here means an external director or an external corporate auditor, who is unlikely to have conflicts of interest with the shareholders of the company. The requirements for an independent executive are basically the same as the requirements for external directors and external auditors under the Companies Act, but directors and employees of the parent company or important business partners of the company are also unable to act as an independent executive, in order to ensure the independence of such executives from the company and its management.

> "The Draft proposes two different approaches to ensure the supervisory functions of external directors are fully effective"

According to the TSE, approximately 70% of its listed companies have appointed external corporate auditors and not external directors. Thus, the effectiveness of such independent executives who are external auditors still remains questionable, as they are still bound by the limitation in their powers that they are unable to vote, as mentioned above.

The Draft (and related supplementary explanations released by the Ministry), meanwhile, proposes several amendments to the Companies Act in relation to external directors. These proposed amendments are based on the presumption that external directors would improve the supervisory functions of the board of directors by exercising their voting rights in board meetings, thereby being involved in the material decisions of the company and the appointment and removal of the representative director. They will also be able to monitor conflicts of interest between the company and its directors or third parties.

The Draft proposes two different approaches in amending the Companies Act in order to ensure the

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supervisory functions of external directors are fully effective. One is to make the appointment of external directors a mandatory requirement for certain categories of companies. The other is the introduction of a new category of company that has a structure designed to adopt external directors (a company with an audit and supervisory committee).

Expansion of scope

The Draft suggests three alternative methods to achieving the expansion of the scope of companies that are required to appoint external directors.

The first is to require a company with a board of corporate auditors to appoint at least one external director if the company is either a 'public company', that is a company with no restrictions regarding the transfer of its shares, or a 'large company', that is a company whose paid-in capital is ¥500 million ($6.32 million) or more or whose debt is ¥20 billion ($252.8 million) or more. The rationale behind this method is that companies of these categories would have the resources to bear the costs for appointing external directors. However, since these companies already have a board of corporate auditors, half of which is required to be composed of external corporate auditors, there is an argument that finding appropriate candidates for an external director would impose an additional burden on these companies.

The second method is to require all companies that have the obligation to file annual securities reports under the Financial Instruments and Exchange Act, for example listed companies in Japan, to appoint at least one external director. The rationale here is that companies within this category have a large number of shareholders due to the fact that their shares are traded on the market and, therefore, it is necessary to implement certain measures to supervise the directors as it is hard to expect such a large number of shareholders potentially around the globe to take on a supervisory role. The supplementary explanations for the Draft state that while these first two alternative methods are being proposed as separate methods, they should not be considered to contradict each other.

The third alternative is to make no amendment at all. This is based on the argument that the appointment of external directors should not be made into a legal requirement, as it may have a negative effect on the flexibility of the corporate governance structure of a company, or it may impose a heavy burden on certain companies, as it will be difficult for some companies to find appropriate candidates for external directors.

Company with an audit and supervisory committee

In order to improve the supervisory functions of a board of directors by ensuring that the powers given to external directors are fully used in supervising the overall management of the company, including any conflicts of interest within it, the Draft proposes to establish a new category of companies, temporarily referred to as a "company with an audit and supervisory committee".

This new governance structure aims to realise the separation of the management and supervisory body of a company, by appointing at least one external director who is not involved in the company's operations and is expected to concentrate on the supervisory and monitoring roles. This governance structure is expected to resolve the difficulties faced by companies with a board of corporate auditors by easing the burden of finding multiple independent individuals, since no external corporate auditors are required. It should also make it easier for companies with committees by removing the need to establish a compensation committee and an appointment committee to a certain extent. This therefore appears to be a more readily adoptable structure for companies that desire to strengthen their supervisory function. The external director of the company with an audit and supervisory committee is expected to act as the auditor and supervisor of the management, by participating in the decision-making process of important business decisions made by the board of directors.

The proposal lists a number of features of a company with an audit and supervisory committee. Any company may choose to establish an audit and supervisory committee by

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stipulating so in its articles of incorporation, regardless of whether the company is a public company, a large company, or neither.

The proposal states that a company with an audit and supervisory committee must have a board of directors and an accounting auditor. It also says that any management decision of a company with an audit and supervisory committee must be conducted by the director(s) appointed by the board of directors.

Finally, an employee may be nominated as a director, so long as he or she is not a member of the audit and supervisory committee.

As for the members of an audit and supervisory committee and the members' powers, the Draft also makes a number of proposals. First, the audit and supervisory committee must have three or more members. The members of the committee must be directors of the company, and more than half of such members must be external directors. They must not be executive directors, or employees of the company or its subsidiary.

The audit and supervisory committee and its members will have the same powers as the audit committee and its members of a company with committees, for example the right to file injunctive suits against a director's illegal actions or actions which are not consistent with the company's objectives.

Finally, the board of directors of a company with an audit and supervisory committee must decide on and implement the company's internal systems in order to ensure the correctness of the business conducted by the company.

Furthermore, in order to ensure the independence of the audit and supervisory committee, the Draft proposes that the members of the committee must be elected by a shareholders' resolution which is separate from that which elects other directors of the company – in other words, those who are not the members of the committee. A director who intends to submit a proposal to appoint a candidate as a new member of the committee to a shareholders' meeting must obtain the prior approval of the audit and supervisory committee.

A member of the committee may only be removed by special resolution of the shareholders. A member may express its opinion in relation to the appointment or removal of any member of the committee in a shareholders' meeting. Remuneration of members must be decided either by a stipulation in the articles of incorporation or by a shareholders resolution.

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The Draft also proposes to allow the board of directors of a company with an audit and supervisory committee to delegate certain business decisions, such as the disposal and assignments of important assets of the company and large amounts of borrowings, to a director who is not a member of the committee.

The Draft states that further consideration is required to allow the delegation of other business decisions to a director.

Amendments to qualifications

As for the qualification requirements of external directors, the Draft proposes two alternatives.

The first is to amend the qualification requirements so that an external director of a company cannot serve as a director or work as an employee of the parent company, and also that certain relatives or family members of the company's directors or employees cannot be appointed as an external director. The Draft states that further consideration is required as to whether particular related persons of a sister company or important business partners of the company should be prohibited from serving as an external director. The rationale behind this is that the requirements for external directors in the Companies Act are not sufficient in ensuring the external directors' independence from the company and its management, since directors and employees of a parent company and important business partners are not disqualified, though they may have an interest in the company and may not necessarily be independent from the company. The Draft states that if the Companies Act is amended in accordance with this first alternative, a disqualification period of 10 years should also be introduced.

The second alternative is to make no amendments at all. The aim of this is that any person with a particular relationship with a company or its directors, such as directors/employees or important business partners of the company or parent company, may have some advantages in supervising the management of the company due to their knowledge, experience and familiarity with the business. They may have the incentive and motivation to take on the supervisory role.

Limitation on liability

Under the Companies Act, if an external director executes a contract with the company to limit his

or her liability pursuant to the provisions of the company's articles of incorporation, the liability of such an external director may be limited to higher of an amount decided by the company within the limits provided in its articles of incorporation, and the minimum amount of liability calculated in accordance with the relevant provisions of the Companies Act. That is, provided that the external directors are acting in good faith and do not commit any grossly negligent acts in carrying out their duties and obligations. If the qualification requirements for external directors are amended as proposed in the Draft, some of the current external directors may become disqualified, and as a result may not be able to limit the amount of their liability pursuant to the Companies Act.

Among the directors who are qualified as external directors under the Companies Act but not under the proposed amendment, there will be certain ones who do not carry out the company's operations and therefore can be considered independent from the company's interests, also with the knowledge, experience and incentives to take on a supervisory and monitoring role for the company. These directors, however, may be unwilling to serve as directors if the provisions of the Companies Act that limit directors' liabilities are not applicable to them. In order to encourage these directors, and certain other directors who do not carry out the company's operation and are primarily expected to play supervisory and monitoring roles, to continue to serve as directors, the Draft proposes that the framework which limits the liabilities of an external director should apply to a director who is not an executive director (a representative director, a director authorised by the board to carry out the operations of the company, or a director who has previously carried out such operations), an executive officer, general manager or any other type of employee of the company.

Uncertain form

Since the Draft is still subject to further discussions, it is not possible to predict at this point what the final amendment of the Companies Act will look like. But considering the fact that many of the problems over the past few years appear to have been caused by the Japanese corporate governance system, it is highly likely that some form of amendment that would encourage the appointment of external directors among Japanese companies will be adopted.

It seems the amendments would be welcomed by most people as they appear to strengthen the monitoring system of Japanese companies and pose desirable changes, especially to the eyes of foreign investors.

Further careful analysis of the methods of encouraging the inclusion of an external director will be required, however, in order to ensure that any changes are fully effective. For example, the requisition only requires one external director to be appointed, and this may not necessarily be sufficient in strengthening the supervisory functions of a board, as their views will easily be outvoted by a majority of the board. Also, the introduction of a new category of company – companies with an audit and supervisory committee – could simply be the creation of another unpopular form of company structure, unless efforts are made to ensure that it becomes an attractive choice.