Recent Developments in Corporate Restructuring Legislation

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The Japanese authorities have recently placed many tools at the disposal of companies planning to restructure, beginning with the introduction of mechanisms for share exchange and share transfer. The 1999 ordinary session of the Diet enacted the Law on Special Measures for Industrial Revitalization on October 1 encompassing measures to support the establishment and development of new businesses and facilitate corporate restructuring in an effort to boost the competitiveness of Japanese firms. Further, it spelt out a program of new legislation to promote corporate reorganization through corporate splits and new restructuring procedures.

Japan's capital markets are in the middle of a structural adjustment phase which is challenging the traditional methods of corporate governance involving managers and shareholders. This report will examine the latest legislative developments regarding corporate restructuring, and consider the outlook for the government's program of "industrial revitalization" given the recent changes that have taken place in the capital markets.

1. Legislative Support and Promotion of Corporate Restructuring

1) Promotion of the global enterprise

Recent years have seen a succession of changes to the Commercial Code and a number of special laws regarding corporate restructuring (Table 1). These special laws also cover such areas as the retirement of equity, appraisal valuation of real-estate, and other economic measures to temporarily support the improvement of corporate balance sheets and maintain appropriate levels of outstanding share issuance (Figure 1).

The Japanese government amended the Commercial Code and anti-Monopoly Law in 1997 with respect to mergers and holding companies in order to better support the global activities of Japanese companies. The government relaxed the competition criteria enforced by the JFTC (Fair Trade Commission of Japan) in order to reduce the cost and time required for merger approvals, and at the same time lifted the ban on the establishment of holding companies and published a set of guidelines to be followed. Following this, in recognition of the fact that the establishment of holding companies was still an exacting process, in 1998 it enacted special regulations regarding the setting up of bank holding companies ("Special laws on the Establishment of Bank Holding Companies"), which allowed "triangular" mergers and preferential tax treatment. Debate then subsequently centered around the introduction of a share exchange system that would simplify the establishment of holding companies and 100% subsidiaries without using cash, which would be applicable to all limited companies. This was to lead to the Commercial Code Reform Bill of August 9, 1999, which came into effect on October 1.[1]

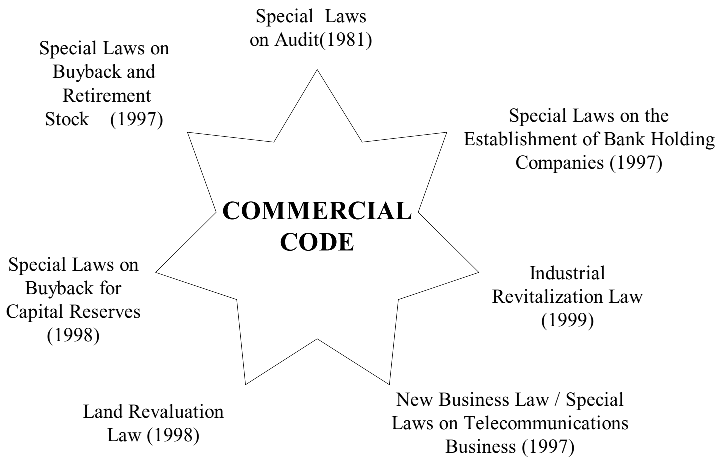
Table 1 History of Legislative Reforms and Corresponding Corporate Restructuring

Date	Legal Reform	Corporate Activity
Oct. 1, '97	Reform to the Commercial Code – "Simplification of Merger Procedures and the Establishment of a Short-form Merger System"	
Dec. 17, '97	Lifting of ban on establishment of holding companies (Anti-Monopoly Law Amendment of (Jun.12, '97)	Daiei is the first company to set up a holding company
Mar. 11, '98	Special Law for the Establishment of Bank Holding Companies enacted, amended financial legislation due to the lifting of the ban on establishment of holding companies (Dec. 12, '97)	No new holding companies set up based on the Special Law for the Establishment of Bank Holding Companies
Dec. 21, '98	JFTC announces "Guidelines for Corporate Combinations"	
Jan. 1, '99	Amendments to the Anti-Monopoly Law reduce the scope of mergers / acquisitions, stock-holdings and business operation transfers subject to pre-notification requirements	Number of merger filings to the JFTC in FY98 reduced to 1,514 (from 2,174 in FY97), and business transfer filings reduced to 1,176 (from 1,546 in FY97)
Feb. 16, '99	The Commercial Code Committee of the Legal System Council approves the "Outline of Partial Amendments to the Commercial Code" (Jan. 27, '99) for the introduction of share exchange and transfer systems, which is then submitted to the Minister of Justice	Based on the revised Commercial Code, Sony announces plans to turn its 3 listed subsidiaries into wholly-owned subsidiaries (Mar. 9, '99)
		Daiwa Securities reorganizes under a holding company structure (using the "shedding method" provided for under the Commercial Code) (Apr. 26, '99)
Jul. 7, '99	The Legal System Council Commercial Code Committee announces draft amendments to the law governing corporate splits (to be presented at the Diet ordinary session in 2000)	NTT splits into separate companies along previous divisional lines and under a holding company (Jul. 1, '99)
Aug. 6, '99	Diet approves the Industrial Revitalization Law and Amendments to the Law on Special Taxation Measures for Industry Revitalization, "Business restructuring, support for establishment of new businesses etc." (enacted Oct. 1, '99)	Japan's *Keidanren* federation of businesses and Ministry of Trade and Industry urge the government to introduce regulations to cover debt-equity swaps and the reduction of over-capacity etc. measures for industrial revitalization (Feb.-May. '99)
Aug. 9, '99	Diet approves Commercial Code revisions "setting up of share exchange, 'short form' share exchange and share transfer systems" (enacted Oct. 1, '99)	Sony and its 3 subsidiaries hold a special shareholders meeting regarding an exchange of shares (Nov. 26, '99)
Aug. 26, '99	Civil Revitalization Law, introducing new procedures for corporate restructuring, approved by the Legal System Council (planned to be presented at an extra-ordinary Diet session Oct. '99)	
by Mar.2000	Corporate accounting to move over entirely to consolidated basis accounting	
by Mar.2000	Corporate accounting to adopt full market-value accounting for financial instruments	
2002	Introduction of a consolidated basis taxation system (planned)	
FY2002	Revisions to the Anti-Monopoly Law (to increase the scope of businesses that can set up holding companies and increase limits on the amount of securities holdings that can be held by large companies etc.)	

Source: Nomura Research Insutitute

1 c.f. M. Hashimoto "The Movement Towards the Creation of a Share Exchange System Intensifies," CRJ Winter 1998, and "The Introduction of Share Exchange and Share Transfer Systems," CRJ Summer 1999.

Figure 1 Special Laws on the Commercial Code to Promote Corporate Restructuring



Source: Nomura Research Institute

2) Consideration of Various Measures to Promote Industry Revitalization

In the long-drawn-out recession that followed the bursting of the asset price bubble of the late 1980s many Japanese companies found themselves wasting away under the burden of excessive production capacity. Under these circumstances, restructuring and consolidation of Japan's industrial groupings became a matter of urgent regulatory concern, and the issue centered around creating a legislative environment that would allow the reorganization and consolidation of subsidiaries / affiliates and business divisions to create slimmer and more efficient corporate groups.

The Japanese government therefore made efforts to tackle the problem of non-performing loans of the country's banks and financial institutions by implementing the Financial Revitalization Law, then set up the Economic Strategy Council and Economic Deliberation Council which were charged with pushing forward debate on measures to reinvigorate the corporate side of the equation. With the aim of carrying on reforms in this area, the Industrial Structure and Employment Reform Council (headed by Prime Minister Keizo Obuchi) decided on the "Emergency Employment Measures and Measures to Strengthen Industrial Competitiveness" on June 11, 1999, and on July 13, it put forward a program of reforms entitled "Regulatory Reform for Job Creation and Industrial Competitiveness" (Tables 2,3). With these the government was aiming to enhance Japanese firms' productivity through the efficient allocation of business resources, which it quickly decided to reinforce with legislation to facilitate corporate restructuring and support the creation of new small and medium enterprises(SMEs). The resulting "Law on Special Measures for Industrial Revitalization(Industrial Revitalization Law)" was then submitted to the Diet on July 23, 1999, and passed on August 6, coming into effect on October 1, 1999 at the same time as the Commercial Code revisions that introduced the share exchange system.

Table 2 Summary of Points in the Emergency Employment Measures and Measures to Strengthen Industrial Competitiveness

1. Promotion of Business Restructuring

We put forward the following measures to create the regulatory framework under which companies will be free to elect their own corporate structure, convert certain business operations and reduce excess capacity, in order to facilitate improvements in corporate financial health through the shifting of management resources to higher productivity sectors, based on principles of corporate self-sufficiency.

1) Companies to be free to elect their own preferred corporate structure

(1) Introduction of share exchange and transfer systems
(2) Introduction of corporate split system
(3) Speedy and transparent application of the Anti-Monopoly Law (regarding merger approvals)
(4) Consideration of a Limited Liability Partnership contract system

2) Enable corporate reconstruction

(1) Introduction of new corporate reconstruction type bankruptcy procedures
Work towards implementation at the next Diet session of new corporate reconstruction type bankruptcy procedures to facilitate the speedy and flexible rebuilding of SMEs.
(2) Set up legal framework for debt-equity swaps
Work towards the establishment of a regulatory framework to allow use of debt-equity swaps, based on mutual consent of both borrower and lender, as one method of tackling the problem of excessive corporate debt.

- Relaxation of upper limits on financial institution equity holdings, clarification of use of equity holdings
- Increase upper limit of non-voting stock issuance for corporate restructuring purposes.

3) Regulatory environment to facilitate strategic corporate restructuring along principles of free choice and the concentration of resources in profitable areas

(1) Simplification of corporate split procedures.
The following measures to simplify and speed up corporate split procedures:

- Review investment in-kind auditing system
- System for lump transfer of debt
- System for simplified transfer of business operations from third party companies

(2) Expand eligibility for stock options
Introduction at the next Diet session of a measure to allow granting of stock options to directors / employees of subsidiaries as well as those of the parent company in order to facilitate restructuring through the establishment of subsidiary operations
(3) Support establishment of companies via EBO and MBO
In order to encourage business restructuring and the spirit of enterprise, the establishment of companies via management or employee purchase of shares (MBO / EBO) will be entitled to receive government support. To this end the limit on issuance of preference shares will be raised, and restrictions on granting of stock options will be relaxed.
(4) Simplify procedures for provision of funds for restructuring purposes
(5) Promote the efficient re-use of ex-factory land
(6) Simplify procedures for assignment of licencing / authorization rights (of ex-company, parent company)
(7) Establish a regulatory framework for debt-equity swaps (as mentioned above)

4) Adjust the regulatory environment to make it easier for companies to introduce changes in accounting practices

Japan's companies will have to introduce many changes to customary accounting practices in the near future – retirement allowance accounting, market-value accounting and consolidated basis accounting. As well as ensuring full disclosure for financial information, the government needs to make changes to several related systems to make it easier for companies to implement these changes.

5) Asset liquidity enhancement and securitizaition

The following measures will be taken in order to free up liquidity in the market for real-estate:
(1) The government needs to quickly finalize debate especially as regards investor protection, and implement a regulatory environment conducive to the promotion of a diverse range of asset-backed security investment products, such as the "Law on Securitization of Specified Assets by a Special Purpose Company" (SPC Law).
(2) Examine issue of securitization of Housing Loan Corporation mortgages and reach quick policy decision.
(3) Credit enhancement by government institutions of asset-backed securities
(4) Further relaxation of regulations governing building / land redevelopment
(5) Early enactment of the "Partial Amendments to the Rental & Leasing Law" which codifies a system for property letting.

2. Promotion of IT research & development

3. Policies to nurture the growth of SMEs and venture companies

4. Tax reform to enhance industrial competitiveness
Examination and early enactment of the necessary tax system and company pension reforms for encouraging asset securitization, achieving strategic company structural and organizational changes, boosting the financial health of companies, nurturing start-ups and venture companies, and implementing a consolidated taxation system with the aim of revitalizing the economy and enhancing industrial competitiveness.

Source: NRI, from the "Industrial Structure and Employment Reform Council."

Table 3 Financial Elements in the "Regulatory Reforms for Job Creation and Industrial Competitiveness"

(1) Creation of a regulatory framework for debt-equity swaps and clarification / relaxation of the 5% rule In order to quickly establish a regulatory framework to allow companies, with the consent of the creditor, to swap debt for equity, there should be clarification of the approval process behind the so-called "5% Rule" (Anti-Monopoly Law Clause 11) which sets a limit on the equity holdings of financial institutions, and also revisions made to the enforcement regulations of the Banking Law.
(2) Reform and deregulation of the OTC Market Reform and deregulation of the OTC market and ensuring a higher level of transparency in order to encourage the growth of venture companies.
(3) Deregulation to promote the growth of the corporate bond market Create an environment conducive to the growth of the corporate bond market, starting with an examination of the whole corporate bond settlement system including regulations regarding registration in order to reduce the length of the settlement cycle.
(4) Expand the number of investment types allowed to pension funds Examine question of / current state of active investment by public pension funds, to lead to a complete investment management framework and an expansion of investment types open to both pension funds and mutual aid associations.
(5) Promote use of cross-shareholdings as company pension fund contributions Not only cash but equities should also be promoted as ways to contribute to company pension funds
(6) Bring company accounting in line with international accounting principles, realization of "latent" gains / losses on real-estate assets The issue of whether unrealized gains / losses on real-estate should be brought on balance-sheet needs to be examined with regard to investor protection.
(7) Expand definition of SMEs Policies to support the creation of SMEs, and to support the application of IT in SME businesses, consideration of reform of the Small to Medium Enterprise Basic Law, and expansion of the definition of SMEs (to include larger firms).

Source: Industrial Structure and Employment Reform Council.

2. Business Restructuring under the Industrial Revitalization Law

The 3 main elements of the Industrial Revitalization Law are: facilitating business restructuring; support for the creation of new businesses and venture businesses by SMEs,[2] and support of research activities that will enhance corporate resources. This report concentrates on those measures to support industrial restructuring.

2 The requirements set forth for SMEs to be eligible for support under the Industrial Revitalization Law depend on the business sector to which it belongs: for "Manufacturing, Mining and Transportation" sectors the criteria are total equity capital or invested capital of ¥100 million or below and 300 or less employees; for "Retail and Service" industries it requires capital of ¥10 million or below and 50 or fewer employees; for the "Wholesale" sector a company must have capital of ¥30 million or less, and 100 or fewer employees (Article 2-5, 1,2 and 3). In addition to companies and individuals, these may also apply to company unions and cooperative associations.

1) Business restructuring operations qualifying for exemptions to Commercial Code requirements

Business operations qualifying for exemption from Commercial Code requirements are defined as those operations that "either are, or will be in the future, highly productive" in comparison to other business areas (i.e. core business operations), regardless of whether they are existing or new business areas. The following activities are then identified (Article 2-2):

(1) "Structural changes" that bring about a considerable increase in productivity

- Setting up, streamlining or expansion of core businesses via mergers, transfers of trading rights / goodwill and assets, company acquisitions, joint ventures.
- Minimization or withdrawal from operations via dismantling of facilities, scrapping of equipment, transfer of trading rights / goodwill and assets, sale or liquidation of subsidiaries.

(2) Revised business processes

- Considerable changes in composition of existing product line-up or services via development or provision of new products or services.
- Substantial production efficiency gains achieved by improvements in productive capacity or introduction of new production methods.
- Substantial efficiency gains or a considerable increase in internal demand through the introduction of new sales methods or new methods of product provision.
- Considerable reduction in production costs via the use of new raw material types or product components or the introduction of new purchasing methods.

The above conditions make liberal use of such abstract terms as "considerable" or "substantial." The so-called "approval criteria" for deciding what is to be considered "considerable" etc. has been left to the Industrial Revitalization Law Implementation Regulations announced by MITI (the Ministry of International Trade & Industry), under whose remit the Industrial Revitalization Law falls, on September 30, 1999. These set out corresponding numerical criteria based on past performance of the company in question or with reference to other examples of "successful" restructuring operations (Table 4).

Table 4 Approval Criteria

Legal Requirement		Content of Business Restructuring Plan, Revitalization Plan
Considerable increase in productivity		Where one of the following is clearly specified (Article 3-6) (1) A 2% or over increase in ROE (Return on Equity) (2) A 5% or over increase in the Tangible Fixed Assets Turnover Ratio (3) A 6% or over increase in Added Value per Employee (= Operating Profits + Personnel Expenses and Depreciation Expenses)
Restructuring Measure	Considerable	Capital increase: increase in equity capital of 3% or above through an increase in paid-up capital (Article 2-2-1, (a))
		Dismantling facilities: the book value of the facility to be dismantled constitutes 5% or more of the total book value of all facilities owned by the company (where multiple facilities are to be dismantled they must total 10% or more of total book value) (Article 2-2-1, (b))
		Scrapping equipment: the book value of the equipment to be scrapped constitutes 5% or more of the total book value of all equipment owned by the company (where multiple pieces of equipment are to be scrapped they must total 10% or more of total book value) (Article 2-2-1, (b))
		Change in composition of services via change in product or product provision: total sales of the new product or service constitutes 1% or more of total sales of the company (Article 2-2-2 (a))
		Cultivation of new demand: %-age growth in sales of the new product or service over the period of the restructuring plan is 5 points or over the actual (%-age) growth in sales of the product or service in question in that industry over the previous 3 business years (Article 2-2-2 (c))
		Reduction in production costs: A 5% or more reduction in per unit manufacturing cost for the product in question (Article 2-2-2 (d))
	Substantial	Production efficiency gains: A 5% or more reduction in per unit manufacturing cost for the product in question. However where a per unit reduction in cost of materials is difficult, a 10% or more reduction in the amount equal to manufacturing cost minus cost of materials is also allowed (Article 2-2-2 (b))
		Efficiency gains in product sales or service provision: A 5% or more reduction in cost of sales per unit for the product or service in question (Article 2-2-2 (c))

Source: Nomura Research Insutitute

(1) Approval process

Companies must submit their business restructuring plans to the relevant government ministry for approval by end March 2003. The business restructuring plans may be drawn up either by the company itself or in cooperation with the ministry. The business restructuring plan must include (1) the purpose, (2) details of the plan and time period over which the plan is to run, (3) funds required and planned procurement method, (4) a breakdown of the specific work to be completed. The approval criteria specify as a rule a maximum 3 years period for the restructuring plan. Once it is approved the company must publicly announce the details of the restructuring plan. Subsequent to approval the company may make amendments to the plan, though these amendments also require approval from the competent ministry.

(2) MBO and EBO schemes

Where the company fails to successfully implement its approved "business restructuring plan," another party (the "Implementing party") may draw up an "Implementation Plan" to make use of the same management and business resources, and submit this plan to the competent ministry for approval. In order for the Implementing party to take over all or part of the operations of the original company in order to carry out the Implementation Plan, the

Implementing party must meet certain criteria[3] that specify a certain level of control over the operations of the original company, which means being either an employee or a director of the original company (Article 6). This is therefore support in the form of an MBO (Management Buy-Out) or an EBO (Employee Buy-Out). The Implementation plan must include (1) details of the business and management resources of the original company to be used, (2) details and time period for the Implementation Plan, (3) funds required and planned procurement method. As per the Business Restructuring Plan, the Implementation Plan is also as a rule limited to a maximum 3 years.

3. Commercial Code Exemptions Applying to the Business Restructuring Plan

Exemptions to Commercial Code requirements that the approved party qualifies for as regards their Business Restructuring Plan are: (1) a simplification of auditing requirements in the case of an investment in-kind; (2) granting of "incentive warrants" to employees; (3) simplified procedures for business transferal, (4) increase in allowed issuance of non-voting stock; (5) debt-equity swaps. These exemptions are treated differently however in the case of Business Restructuring Plans and Implementation Plans.

1) Simplification of investment in-kind auditing requirements

Where companies use assets other than cash to make an in-kind investment when setting up a subsidiary or making a capital increase, the assets used may be property, real-estate, bonds, marketable securities, trade rights or goodwill etc.. In order that the value of these assets is not inflated and is a fair reflection of their real value, a company has to apply for an auditor to be appointed by a Court of Law (Article 173 of the Commercial Code)[4]. However, since this is a costly and time-consuming procedure, companies tend to avoid the use of in-kind investment.

The Industrial Revitalization Law therefore stipulates that where, according to the approved Business Restructuring Plan, a company will acquire over half of the issued shares of a newly established company through an investment in-kind or business transfer, then an audit is not required. However they must employ a Certified Public Accountant or auditor to examine the Articles of Incorporation to testify that they are in order. This same exemption applies to the share exchange and share transfer systems (Commercial Code, Article 354).

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3 According to the Approval Criteria – (1) where 1/3 or more of total outstanding issuance (limited to those with voting rights) of a newly set up company are purchase or held, or (2) 1/5 or more of total outstanding issuance (voting rights only) are purchased or held, and at least 1 person is a director of the newly established company.

4 An audit is not required however when any of the following apply: (1) the asset value of the investment in-kind is not more than 1/5 of the company's equity capital, and not more than ¥5 million; (2) when the price as defined in the Articles of Incorporation of marketable securities used as an in-kind investment do not exceed the actual market price; (3) if the investment in-kind is real-estate, that legally approved Articles of Incorporation exist and a surveyor has appraised the value of said real-estate.

2) Grant of incentive warrants to employees

Under the current Commercial Code, the awarding of stock options is limited to the employees of the issuing company (Commercial Code Article 2-2-3, Article 280-19-1). Currently therefore many companies choose to issue stock purchase warrants to employees of subsidiaries and affiliates, so-called “incentive warrants.” The Industrial Revitalization Law therefore allows the issuing of stock options to employees or directors of affiliates of an approved company (Article 9).

The limit on the total issuance of new shares via stock purchase warrant or stock option exercise has been raised to 1/4 of total outstanding issuance (as opposed to the 1/10 limit under the Commercial Code) (Industrial Revitalization Law Article 9-3, Commercial Code 280-19-3)[5].

3) Exceptions regarding transfer of business operations

In order to effect a transfer of business operations a shareholders’ resolution is required (Commercial Code Article 245). The Industrial Revitalization Law introduces the same procedures as for short-form mergers and short-form share exchanges. Where the “approved Business Restructuring Plan” calls for the transfer of the entire business operations of another company, a shareholders’ resolution is not required if the value of the business to be acquired does not exceed 1/20 of the net assets according to the most recent balance sheet of the acquiring company (Article 10). In this case a resolution of the board is required, and the shareholders must be notified within 2 weeks following. It prescribes procedures for share appraisal rights for those shareholders who oppose the transfer, and if the number of opposing shareholders amounts to 1/6 or more of the total shares, a special shareholders’ resolution then becomes necessary. It further allows for the transfer of debt to take place along with the transfer of operations without having to secure the approval of each creditor. The acquiring company need only notify the creditors individually that they can lodge any objections with the company (Article 11).

4) Debt-equity swaps

The new law also recognizes the issuance of equity to replace the debt of a creditor (a debt-equity swap), as per the U.S. where one bail-out option of a company in danger of defaulting is to apply to replace its debt with equity. There are certain conditions attached, firstly that this must be done with the mutual consent of the creditor and the debtor company.

The outline draft of the “Civil Revitalization Law”[6] (provisional title) approved by the Bankruptcy Law Committee of the Legal System Council on July 23, 1999 also included

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5 Companies certified under the New Business Law or the Postal Exceptions Law can issue up to 1/3 and 1/5 respectively of their total outstanding issuance.

6 Bankruptcy procedures for the rehabilitation of failing companies consist of closing down the company under the Commercial Code, and procedures dictated by the Company Revitalization Law and negotiated settlements under the Composition Act. While the Civil Revitalization Law can be widely used by other corporates and SMEs as well as limited companies, it also allows for the reconstruction of a company while keeping on the current management team. With the introduction of the Civil Revitalization Law the Composition Law was abolished.

provision for “debt-equity swaps” as a new method of recovering a company which had a high chance of defaulting on its debt.[7] Rather it was included in the Industrial Revitalization Law as the government wanted to quickly plug the gap in the Commercial Code by providing one more method of rescuing companies at risk of bankruptcy or in need of rehabilitation.

The government feared however that the use of debt-equity swaps might put companies in the position where over 5% (the current limit according to the Anti-Monopoly Law) of their equity was in the hands of a single financial institution. It therefore announced a working policy that each individual case of a financial institution holding over 5% of a company’s total issuance (10% in the case of insurance companies) would need to be approved by the JFTC. If this equity stake was part of a Business Restructuring Plan under the Industrial Revitalization Law, the JFTC would then approve such holdings for a period of one year as long as: (1) the large equity stake did not result in excessive influence over the company, and (2) it would not hamper competition in that particular industry sector.

5) Raising Limit On Issuance Of Non-Voting Stock

The upper limit on the issuance of non-voting shares in the case of a debt-equity swap was also raised from 1/3 of total issuance as allowed under the Commercial Code, to 1/2 (Article 13). Also new companies set up via MBO or EBO ("Specially Approved Implementation parties"), are now allowed to issue non-voting shares up to 1/2 of the outstanding total issuance (Industrial Revitalization Law Article 12, Commercial Code Article 242-1-3).

6) Preferential Tax Treatment

The Law on Special Taxation Measures for Industrial Revitalization introduced as part of a package with the Industrial Revitalization Law provided for the following preferential treatment to aid a company’s “business restructuring plan”. Their application would also depend on approval from MITI.

- The carry forward period for losses arising from the scrapping of certain equipment was extended from 5 to 7 years, or the company could choose to receive a tax refund by carrying the loss back to a previous year.
- Deferment of asset transfer tax for in-kind investment in jointly established subsidiaries (where the equity holding is 25% or more).
- Advance depreciation of land, buildings etc. property replaced by purchase.
- Special depreciation of equipment for certain industries purchased as part of a reform program.

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7 Concerned at the recent economic situation and string of bankruptcies, from September 1998 the Legal System Council debated the introduction of a new set of company rehabilitation procedures, and the resultant draft bill – the “Civil Revitalization Law” (provisional name) was approved in unusual haste on July 23, 1999. After approval in late August by the Commercial Law Committee of the Legal System Council it was presented at an extra-ordinary session of the Diet in autumn 1999, bringing forward the enactment of the Law and introduction of these new measures to April 2000.

The new tax regulations also lowered the registration tax payable when setting up a new company, a joint-venture or a capital increase. For example, the registration tax on a capital increase was lowered from 0.7% to 0.35% of the total value of capital raised.

4. Draft Proposal for Corporate Split Legislation

The same Commercial Code Committee of the Legal System Council that brought in the share exchange and share transfer systems has quickly moved on to tackle the question of codifying legislation on corporate splits. A “corporate split” is where a company spins off one or more of its divisions, either setting them up as separate companies or transferring operations to another company. Though there are no specific legal regulations governing this activity at present, these may be handled under the laws governing investments in-kind, establishment of companies after the fact, or property transfer. However the procedures involved are enormously complicated, while there are no regulations concerning the allocation of shares in the spun-off division to the shareholders of the original company.

The new legislation would enable the separate treatment of such corporate splits. In response to the Industrial Competitiveness Council’s urging for an early codification of corporate split legislation [8] ahead of what had been envisaged in the government’s deregulation program, the Legal System Council Commercial Code committee put forward a draft set of proposals [9] for revisions to the Commercial Code on July 7, 1999. The Commercial Code reform bill for establishing Corporate Split legislation is set to be presented to the next regular Diet session for enactment sometime during 2000.

1) The 2 Types of Corporate Splits

The draft proposals envisaged two types of corporate splits – “Shinsetsu-Bankatsu (S split)” and “Kyushu-Bunkatsu (K split)” (Figure 2). The S split entails the establishment of a new company to which the assets and liabilities are transferred through an in-kind investment. The K split entails the transferal of assets and liabilities through an in-kind investment to an existing company, and then a simultaneous S split and merger. In both cases a court appointed corporate inspector is not required.

There are also two patterns of shareholding following a corporate split – one (spin-off type) where the shares in the newly established company are held by the original company, the other (split-off type) where the shares in the split-off are allocated to the shareholders of the original company (Figure 3).

Further, the proposed legislation also provides for a “short-form corporate split” where, as is the case with mergers and share exchanges, approval of the shareholders of the original company at a general meeting is not required.

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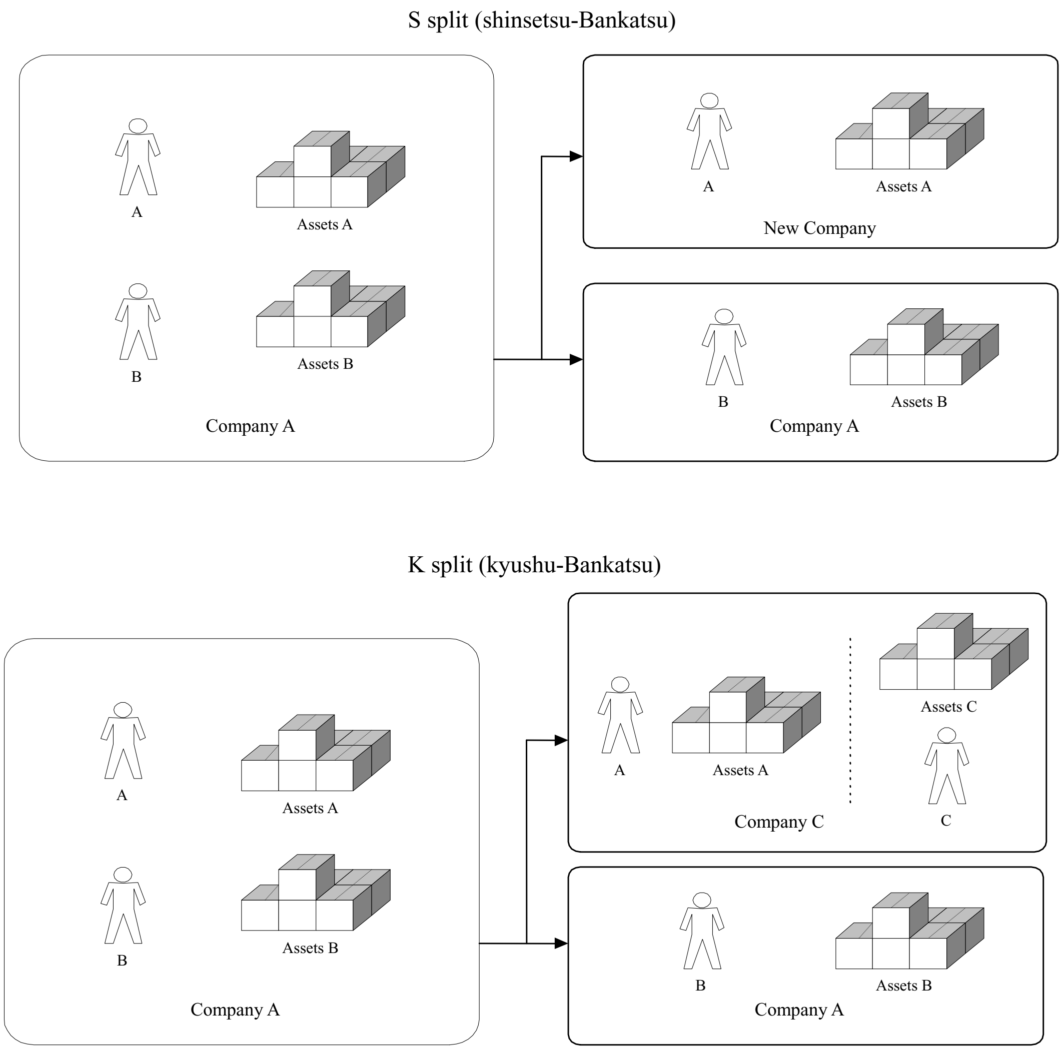
8 The “3-year Deregulation Program” ordered by the Cabinet on March 30, 1999 called for an investigation of corporate split legislation to be completed during FY2000.

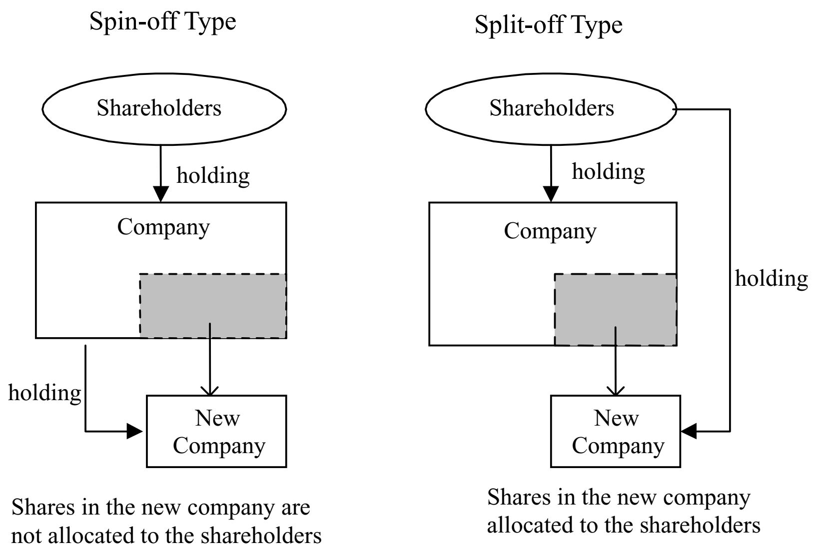
9 September 1, 1999 was the deadline for comments.

Figure 2 Statutory Types of Corporate Splits



Source: Nomura Research Insutitute

Figure 3



Source: Nomura Research Insutitute

2) Procedures

(1) S Split

(a) Corporate Split Plan

In the case of a S split, a corporate split plan must be drawn up and submitted for approval via a special resolution from the shareholders at a general meeting. This must include the following:

1: Articles of Incorporation of the company to be formed by the split

2: Number and type of shares to be issued by the new company, and details of share allocation to the original company or its shareholders

3: Capital and reserves of the new company

4: Property and debts to be inherited by the new company

5: Names of directors and corporate auditors of the new company

6: Where the shares in the new company are to be allocated to the shareholders of the original company, the resulting capital and reserves of the original company after the spin-off has been completed.

7: Details of any retirement or reverse stock splits

8: Timing of the split

9: Details where more than one company is involved in the split and incorporation of the new company

Item 2 above also recognizes the allocation of shares to the shareholders of the original company in addition to allocation to the original company itself. In item 6, while the assets of the original company will decrease through the split, if the original company holds the shares of the new company then the value of those shares will be equivalent to the value of the assets it has lost, so the overall position will be neutral with no need to decrease the original company's equity capital. Item 7 however allows for a share retirement or reverse stock split since the decrease in net assets of the original company from the split may, if its outstanding issuance is unchanged, result in net assets per share falling below the minimum legal requirement of ¥50,000.

Furthermore, while as a rule it is prohibited for the split original company and the spun-off company to carry out the same business in either the same or neighbouring towns for a period of 20 years after the split, this restriction may be waived if a special term is made in the corporate split plan.

(b) Treatment of creditors and shareholders

As a corporate split (where the shares in the new company are held by the original company) involves a transfer of debt as well as of assets, care needs to be taken that the interests of the creditors are protected in the transfer procedure. Under Japanese Civil Law, for the debt obligation to be transferred to a third party the agreement of each creditor is required, something that is difficult to obtain when there are many different creditors. Therefore in the case of a corporate split, within two weeks after the shareholders have given their approval through a special resolution, there must be an announcement to this effect to the creditors, who then must reply within those two weeks if they have an objection to the transfer of the obligation, in which case the outstanding loan may be returned. If they do not, then this is treated as consent.

The original company must make the documentation related to the corporate split available for inspection by its shareholders at its offices both before and after the shareholders' meeting, and must recognize share appraisal rights to any shareholders opposing the split.

(2) K Split (where a division of a business is split into another company)

A K split involves first the conclusion of a "corporate split contract" between the original company and the third-party company (assignee company) who will be absorbing the spun-off division. This contract differs from the corporate split plan of the formation split in the following ways: where shares of the assignee company are to be allocated to the shareholders of the original company, the contract must include details of the allocation ratio and of any adjustment payments to be made; it must also include the date of the meetings at which the split contract was approved by the shareholders of the assignee company, and the names of any directors and corporate auditors newly appointed by the assignee company as a result of the split.

(3) Short-form split procedures

A short-form corporate split is applicable in the case of a S split where the shares of the new company are to be held by the original company, and the value of the assets minus the debts to be held by the new company is no more than 1/10 of the total net assets of the original company according to the most recent balance sheet. Since this is considered as having minimal impact on the shareholders of the original company, a shareholder resolution approving the split is not required.

In the case of an absorption split, the original and assignee companies must conform to the following requirements to qualify for a short-form split that does not require the formal approval of their respective shareholders. For the original company, where the new shares from the split are not to be allocated to its shareholders, the value of the assets minus the debts transferred to the assignee company must not exceed 1/10 of the net assets of the original company according to the most recent balance sheet. For the assignee company, the total number of new shares from the split must not exceed 1/20 of the assignee company total issuance, and where there is a share adjustment payment to be paid to the shareholders of the original company, that amount must not exceed 1/50 of the net assets of the assignee company according to the most recent balance sheet.

5. The steady pace of structural reform in Japan's capital markets.

Japan's so-called "Big Bang" rolling program of regulatory reform has brought about the restructuring of its financial institutions, a sharp rise in M&A activity backed by foreign capital, the beginning of the end for Japan's network of corporate cross-shareholdings and a greater emphasis on fiduciary responsibility on behalf of its institutional investors through the relaxation of pension fund investment regulations. It is perhaps moving faster than expected towards Big Bang's final goal – free, fair and global financial markets.

1) Changes in shareholder distribution make securing a quorum at shareholder meetings difficult

According to the "Share Distribution Survey - Fiscal 1998" published by The National Conference of Stock Exchanges on July 5, 1999, the absolute number of individual shareholders across Japan increased sharply for the third successive year, rising some 440,000 on the previous year to a total of 28.3 million. Moreover the proportion of shares held by non-Japanese (on a market value basis) also rose to its highest level since the survey began, 14.1% (Figure 4)[10]. Despite the effect of Japan's largest-ever flotation - NTT DoCoMo, which itself accounts for 10% of the total market capitalization of the 1st section of the Tokyo Stock Exchange, and actually caused the proportion of corporate shareholdings to rise in FY98, the asset rationalization measures brought about by the large-scale restructuring of Japan's financial institutions and company securities portfolios in advance of the introduction of market-value accounting has meant that the inter-locking network of corporate cross-shareholdings is beginning to dissolve.[11]

In the past 1 or 2 years the proportion of shares held by non-Japanese has been rising, so that now there are over 50 listed companies who have over 1/3 of their shares held by non-Japanese. In order for companies to forge ahead with restructuring measures such as mergers or share swaps, they need to obtain a special resolution from their shareholders (at a meeting where a majority of the shares have to be represented, and approved by over 2/3 of those in attendance). Now however there are a growing number of companies where overseas investors make up a significant proportion of their shareholders, without whose attendance the quorum stipulated in the Commercial Code cannot be secured and a resolution cannot be passed. This so-called "quorum problem" is a serious matter for public companies who are intent on drastic restructuring measures, and who then have to canvass their foreign shareholders for attendance at a tightly scheduled shareholders meeting.

FY98 saw a dramatic year-on-year rise in M&A activity by foreign investors targeting Japanese companies. Further, a more aggressive type of M&A has appeared for the first time in Japan – note Renault's equity stake in car-maker Nissan, and the success of C&W's hostile bid for IDC – and the highly protective attitude to the influx of foreign capital that was prevalent 10 years ago in Japan is now rarely seen. As this shift to a more internationalised investor-base is being brought about not only by those Japanese companies desiring better access to the international capital markets, but also by those companies with purely domestic operations, it should continue for the foreseeable future.

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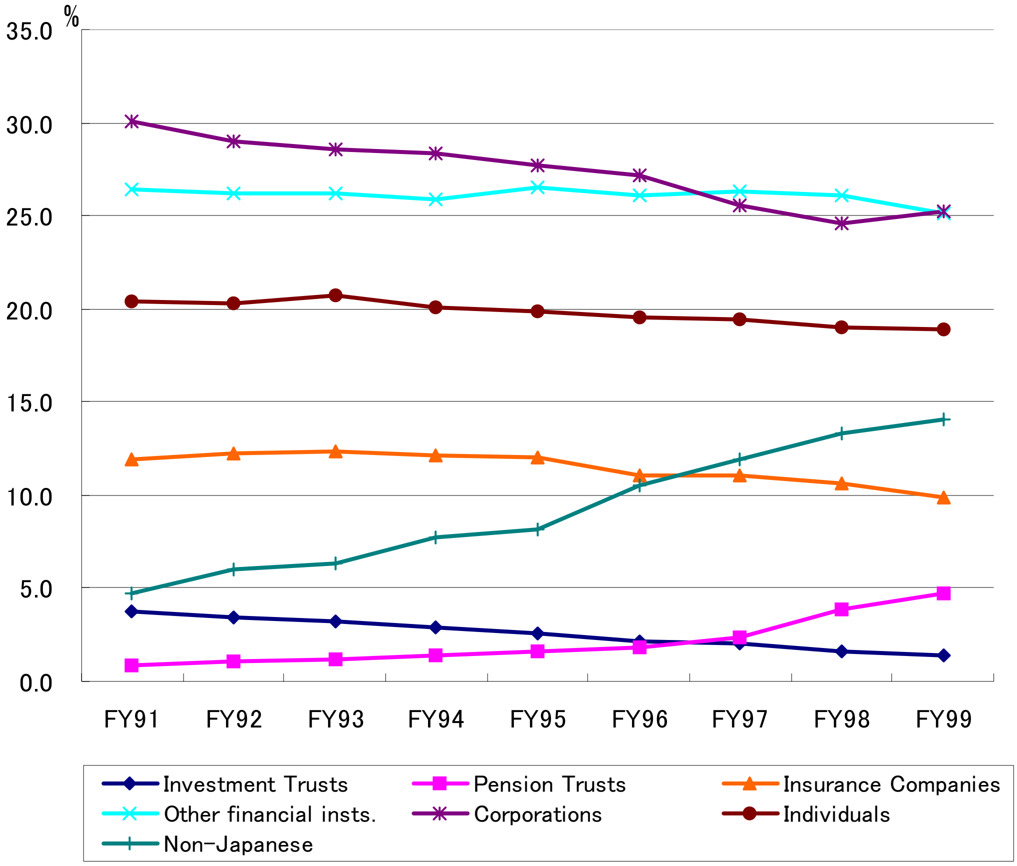
10 The "FY1998 Share Distribution Survey" of OTC listed firms published by the Japan Association of Securities Exchanges in July 1999 however revealed a 1.1 point decrease in the percentage of shares held by non-Japanese, falling 11.2% year-on-year on a market value basis.

11 According to the Nomura Financial Research Center, the proportion of cross-shareholdings as at end FY98 had declined 2.8% year-on-year to 23.6%. This means that over the 10-year period since 1990 this proportion has declined from about 1/3 to about 1/4.

Figure 4　Share Distribution Survey



Source:　The National Conference of Stock Exchanges

2) Pension Funds Turn Their Attention to Issues of Fiduciary Responsibility

Though employees' pension funds have the power to instruct the trust banks, insurance and investment advisory companies who manage their assets as to how they wish to exercise the voting rights for the shares in the companies they hold, up to now these asset management companies have tended to refrain from taking any position on company board decisions. This is changing in response to the 1998 decision by the Pension Fund Association (PFA) to formulate a policy regarding the exercise of these rights, which prompted the financial institutions who manage their funds to take their fiduciary responsibilities much more seriously and draw up their own set of guidelines for the exercise of voting rights in time for the June 1999 season of annual meetings, as well as formulating internal company operational procedures. The PFA revised its "Investment Policy Guidelines for Pension Fund" in October 1999 by inserting a new clause that called for investment managers to exercise voting rights with the aim of increasing the profits of the members of the Association on whose behalf they are investing. One sub-committee of the PFA charged with researching the subject of fiduciary responsibility is codifying its "Pension Fund Investment Guidelines" that will cover pension fund investment processes in exhaustive detail, and is set to publish a draft version of the document by the end of 1999, in which it plans to highlight the neglect of voting on power of attorney issues and company board proposals as examples of bad practice by asset management firms.

3) Perspective on Japanese Corporate Governance

Now that companies in Japan are dissolving their traditional group-based cross-shareholdings, the biggest holders of equities will probably be institutional investors such as pension funds, trust banks and also foreign investors. With asset managers now called on to exercise voting rights on behalf of pension funds with an eye on profit maximization, all investor groups will now be taking a much harder line with management in order to boost investment performance and realize shareholder value.

The weak position of the board of directors has often been pointed out as one major problem with corporate governance in Japan, and Sony for example has taken steps to tackle this by introducing a sweeping set of reforms in 1997, including an executive officer system, outside directors, and heavily reducing the number of board members. However, this restructuring operation smacks of being a one-off, neither achieving the necessary re-alignment of the firm along risk management lines, or turning it into a self-propelling dynamic that can continue with a management reform program. Japanese companies have to not only perform speedy and accurate disclosure, but also clearly state the corporate governance principles on which the company operates, and institute a system of checks on management that will ensure full accountability to shareholders alongside a company structure that has the principle of continuous "reform from within" at its core[12].

A market where principles of good corporate governance are widely practiced, where companies are fully accountable to and strive to achieve good returns for their shareholders, is self-reinforcing and acts to make the whole market more efficient. However as the globalization process continues to make companies and investors (shareholders) more internationally active, unless Japan's exchanges can attract the world's investors through being both highly efficient and transparent, they may well see these investors taking their business abroad. It is now vital for the standard of disclosure among listed companies in Japan to rise so that shareholders can feel safe investing.[13]

6. Future Outlook

The Industrial Revitalization Law appears to be spurring on the cause of corporate restructuring. With plans being announced by Nippon Steel, Sumitomo Metal Industries and Kawasaki Steel to scrap their excess capacity and form a business alliance, there have been a succession of restructuring plans announced that want to take advantage of the special exemptions provided by the Industrial Revitalization Law[14]. However, in so far as they receive preferential tax treatment, the number of restructuring plans receiving exemptions under the Industrial Revitalization Law will be limited.

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12 In the U.K. and the U.S., in contrast to Japan, an independent board of directors is viewed as an indispensable tool in monitoring the activities of management.

13 At the 4th ICGN (International Corporate Governance Network) annual conference the Tokyo Stock Exchange put forward its own role as a promoter of good corporate governance in order to enhance the value of the shares listed on the exchange, and announced plans to hold a symposium where listed companies could develop and make public their own corporate governance regulations.

14 Each restructuring plan of Sumitomo Metal, Mitsubishi Motors and Oji Paper has been approved.

It was nevertheless possible for merger and business transfer type corporate splits to be carried out before the recent legislative changes, and indeed they were. However, now that the speedy implementation of corporate restructuring measures is becoming an important management issue and a major factor behind the valuation the market puts on a company, the need for a much better environment under which to carry out these reforms has been heightened drastically. Now that cross-shareholdings are being dissolved, companies seen as badly managed will find the market pressure to reform intensifying. When compared to U.S. companies, Japan's firms are not so advanced in the development of defensive tactics to fend off take-overs, and so without implementing drastic reforms may well find themselves on the receiving end of a sudden upsurge in M&A activity.

In FY2000 with the enactment of regulations governing corporate splits and corporate rehabilitation based on the Civil Revitalization Law, the legislative framework for corporate restructuring will be more or less complete. Further, the government has announced its intention to keep the special Commercial Code exemptions being brought in with the Industrial Revitalization Law in place beyond April 2003.[15] While it is of course important that Japan's firms restructure quickly, it is also important in terms of gaining the understanding of shareholders and in developing the function of a board of directors that is responsible to its shareholders, that the means by which it is achieved can be decided and pursued by the company itself. With the imminent switch over to consolidated and market value basis accounting, Japan's companies will have to restructure while concentrating more than ever on the focused and efficient application of their group resources.

15 According to the Nikkei Shimbun financial daily, August 9, 1999.