February 5, 2019

Ministry of Economy, Trade and Industry
Corporate System Division
Economic and Industrial Policy Bureau
Kasumigaseki 1-3-1
Chiyoda-ku, Tokyo 100-8901

To Whom it May Concern:

The American Chamber of Commerce in Japan (ACCJ) appreciates the opportunity to submit the following comments in response to the solicitation of opinions/information on fair M&A dated December 28, 2018 (the "Solicitation for Comment").

We applaud the formation of the Fair M&A Study Group (the "Study Group") to discuss whether or not the *2007 Guidelines for Management Buyout (MBO) to Improve Corporate Value and Secure Fair Procedures* (the "MBO Guidelines") should be revised. The ACCJ has had longstanding concerns regarding the governance of Japanese listed companies in respect of transactions involving conflicts of interests between the company and its management or controlling shareholders. The ACCJ has publicized and called for the implementation of legal changes to address such concerns in, among other policy papers and public comment letters, the following documents (collectively, the "Corporate Governance Viewpoints"):

- Proposed Amendments to the Companies Act to Further Strengthen Corporate Governance Reform (2018) (the "2018 Corporate Governance Viewpoint");
- Further Implement Corporate Governance Reform in Japan to Spur Investment and Encourage Sustained Economic Growth (2015);
- Calling upon the LDP to Follow Through on its Campaign Promise to Reform Corporate Governance at Public Companies in Japan (2014); and
- Ensure that Amendment of the Company Law Achieves its Original Objective: Improvement of Corporate Governance at All Public Companies in Japan (2012).

We believe that a robust M&A market is essential for Japan to reallocate resources to more productive uses that create shareholder and societal value and drive economic growth. However, a robust M&A market can only be achieved if all market participants are assured that the M&A process is fair and that corporate management and other controlling parties are not able to use their positions as insiders to manipulate the corporate decision-making process at the expense of public shareholders.

Based on the foregoing, the ACCJ is pleased to submit our views, focusing in particular on the scope of conflict-of-interest transactions that should be subject to special procedures to ensure fairness, whether such special procedures should be soft-law "guidelines" or enacted through legally binding amendments to the Companies Act, and our recommendations concerning the composition and role of a special committee in respect of such conflict-of-interest transactions.

We note that the ACCJ has not had sufficient time to address through its internal process all of the issues raised in the Solicitation for Comment, such as fairness opinions and valuations, market checks and majority-of-minority conditions, but that we would hope to have the opportunity to comment on such issues prior to the issuance of any final proposals by the Study Group.

Scope of Transactions Subject to Special Procedures concerning Fairness

We agree that the scope of the Study Group's review should not be limited to transactions that are technically within the definition of a "management buyout". As indicated in the Solicitation for Comment, there are many variations of transactions that involve conflicts of interest that are not technically MBOs, including certain new issuances of shares and transactions between a company and its controlling shareholder. The Corporate Governance Code takes the same view, with Principles 1.6 and 1.7 urging companies to "establish appropriate procedures" with respect to "a company's capital policy that results in the change of control or in significant dilution, including share offerings and management buyouts" or "when a company engages in transactions with its directors or major shareholders (i.e., related party transactions)".

Soft Law (Guidelines) vs. Hard Law (Amendments to Companies Act)

Although we agree with the objectives of the Study Group to improve the fairness of Japan's M&A market, we do not believe that a limited revision of the MBO Guidelines is sufficient to protect the shareholders of all Japanese listed companies. The Guidelines, as non-binding soft law without clear legal remedies for shareholders in the event of non-compliance, are insufficient to adequately protect shareholders in fundamental corporate transactions in which managers or controlling shareholders have an inherent conflict or self-interest.

Other careful observers of Japan's corporate governance have reached the same conclusion. In the CLSA/Asian Corporate Governance Association's most recent survey of the corporate governance systems of major markets in Asia, Japan's ranking fell from four in 2016 to seven (tied with India, and below Thailand, Taiwan and Malaysia) in 2018, with the first cited reason being an "unbalanced focus on soft law compared to hard law" with "[corporate governance] rules and shareholder rights remain[ing] weak in many areas."[1]

Soft law, such as the Corporate Governance Code, may be adequate for certain aspects of corporate governance such as encouraging dialogue with

[1] *CG Watch 2018: Hard Decisions*, CLSA and Asian Corporate Governance Association, December 5, 2018.

shareholders. However, matters that are fundamental to the rights of shareholders and a fairly operating M&A market, including protections for shareholders in MBOs and other change-of-control transactions in which management or a controlling shareholder have a conflict, should be mandatory provisions for all listed companies under the Companies Act. Accordingly, the ACCJ urges the Study Group, in addition to proposing appropriate revisions to the MBO Guidelines, to make concrete proposals to the Government of Japan and the Ministry of Justice regarding amendments to the Companies Act that are required to implement such protections.

Use of Special Committees

As the ACCJ has emphasized in its Corporate Governance Viewpoints, we believe that it is critical for the protection of public shareholders that transactions involving inherent conflicts or self-interest be approved by a "special board" consisting solely of independent outside directors.

Currently, because certain Japanese listed companies do not have sufficient independent outside directors to form an effective special committee and for other reasons, many companies have relied on informal "special committees" consisting of non-directors to consider and make recommendations on key corporate decisions (such as MBOs). The ACCJ continues to believe that such extra-legal "committees" of non-directors, who are not elected by shareholders and do not clearly owe fiduciary duties to shareholders or the company, are problematic.

In light of the current governance framework which provides listed companies three different governance options and does not require all listed companies to have a significant number of independent outside directors, in order to guarantee protection of all shareholders and consistent with our 2018 Corporate Governance Viewpoint, we call for shifting the burden of proof from shareholder plaintiffs to defendant directors in connection with shareholder derivative claims alleging that a director of a public company breached his or her duty of due care in approving board decisions where the manager has an inherent conflict or self-interest, unless such decision was made by a "special board" consisting solely of independent outside directors. This change should be accompanied by an amendment permitting a board of directors to formally delegate decision-making authority on specific matters to a "special board" consisting entirely of independent outside directors. Article 373 of the Companies Act already sets up a framework for such a "special board". It should be appropriately amended and applied to all three corporate governance structures.

The board decisions subject to this rule should include, among other matters, (a) approval of material transactions with affiliated parties (such as controlling shareholders), and (b) decisions relating to the control of the company, such as resolutions to adopt takeover defenses or to recommend or approve extraordinary transactions such as mergers, share exchanges, MBOs or other transactions resulting in de-listing or loss of liquidity to the public shareholders. The Study Group should also consider whether, in the case of transactions with controlling shareholders, the transactions should have additional procedural protections, such as a majority of the minority tender or vote condition, in order to shift the burden of proof (which is the case under Delaware law).

If these decisions are approved by a special board consisting of independent outside directors, the business judgment rule would apply and a plaintiff alleging that the decision resulted in damages to the company would bear the burden of proof to show a breach of fiduciary duties. If the decisions are approved by a board consisting of directors who are not independent and if the plaintiff shareholder demonstrates that the damages resulted from the board's decision, the directors who voted for the decision would be required to bear the burden of proof in demonstrating that they fulfilled their duties of due care and loyalty in connection with such decision. In short, those directors would be held accountable for fully explaining their decision without requiring the plaintiff to succeed in the nearly impossible task of acquiring full information and facts about an internal board decision.

Shifting the burden of proof to directors in respect of decisions not approved by disinterested independent outside directors is a tested approach in Delaware, the most common jurisdiction in which U.S. public companies are incorporated and a jurisdiction at the forefront in establishing global best practices in corporate governance. As in Japan, most actions by a Delaware corporation's board of directors are protected by the "Business Judgment Rule". Under the Business Judgment Rule, actions by a board of directors will be protected by the courts unless the plaintiff stockholder can prove by a preponderance of the evidence that the directors' decision involved a breach of fiduciary duty. In decisions where directors have a material interest in the decision (such as a personal financial benefit in a transaction that is not available to all stockholders), the decision will not be protected by the Business Judgment Rule and the burden of proof shifts to the interested director to show that the transaction was entirely fair, <u>unless</u> that decision is made by a committee of independent outside directors or where a majority of the board's directors is independent and disinterested.

We are confident that our proposal can be implemented without undue hardship. Many Japanese listed companies currently have sufficient independent outside directors to form a special committee and obtain the protections offered by our proposal. Furthermore, companies that currently have insufficient independent outside directors would have time before our proposal is implemented to identify and nominate additional independent outside directors if they so choose.

In summary, we believe that our proposal would be a substantial step in protecting shareholders from conflicts of interest that arise in connection with MBOs and other material related-party transactions while simultaneously providing an incentive to Japanese public companies to voluntarily appoint a sufficient number of independent outside directors.

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The ACCJ appreciates the opportunity to provide input in connection with the Study Group's discussions and hope that we will receive a further opportunity to comment on any final proposals by the Study Group.

Sincerely,
American Chamber of Commerce in Japan