

Case

Case concerning the unilateral dissolution of a male-female relationship outside of marriage and unlawful act (tort) liability

(Supreme Court, November 18, 2004 Judgment; *Hanrei-jihō* No. 1881 p. 83)

Keywords : Unilateral dissolution of a male-female relationship outside of marriage,
Unlawful act (tort) liability

[Facts]

The plaintiff 'X', a woman, and the defendant 'Y', a man, were introduced to each other through a marriage consultation service in November 1985, and were engaged the following month. However, they broke off their engagement in March 1986. The relationship of X and Y continued after the end of the engagement for about 16 years until 2001.

Although X did not want children, she gave birth to two children upon the strong wishes of Y. Although X and Y had occasionally cooperated by working with each other and traveling together, they had lived separately. X and Y were economically independent of each other, and did not own common property. Based on prior decisions between X and Y, and given X's desire to avoid the burden of raising children, X did not raise the two children, and at the times of their respective births, X received a considerable amount of money from Y for the expenses associated with the birth, and so on. Moreover, X and Y both stated that they gave notification of the births with the notification of the marriage at the same time, and gave a notification of divorce by agreement soon after that. The reasoning for this was their concerns over the legal disadvantages suffered by illegitimate children.

In 1996, X had accepted a new post at a distant university. Y got to know a female work colleague, 'A', and began a relationship with her in 2000. Y and A decided to get married in April 2001. In May of the same year, Y told X that he had decided to marry another woman and wanted to break off the relationship that he had had with X until this time. In July, Y and A gave notification of their marriage.

X claimed damages of ¥5 million yen in compensation against Y for mental anguish suffered by both the sudden, unilateral notification of the termination of their relationship by Y, and the fact that Y had married A.

In addition, there was no evidence from X and Y's relationship that they had reached an agreement with regard to the continuation of their relationship under which neither could leave the relationship by way of marriage or otherwise with another person without the other's permission.

At first instance (Tokyo District Court, December 25, 2002 Judgment: Unreported), the court dismissed X's claim. It could not be said that X and Y's relationship was that of a couple by law, and therefore, they could not be considered to have had lifelong duties to mutually cooperate and assist one another, nor was it the kind of permanent relationship that could not be dissolved by the unilateral intentions of one person. Hence, the continuation of the relationship could not be forced upon Y. X appealed this decision.

In the second instance (Tokyo High Court, August 27, 2003 judgment: Unreported), the court stated that given the facts of the relationship, X and Y continued to recognize each other as being their "significant other". However, the court added that it was unsatisfactory to assume that Y had ended the relationship suddenly and unilaterally without the consent of X, simply because it was unfaithful to X's one-sided expectation about the continuation of the relationship. The Tokyo High Court admitted the claim by X, limiting the payment to ¥1 million yen in compensation and dismissed the remainder. Y appealed the decision.

[Judgment]

For the reasons given below, the Supreme Court reversed the part of Y's loss from the original judgment, and agreed with the judgment at first instance to deny X's claim.

The following is clear from the facts:

The relation of X and Y lasted about 16 years, two children were born in the relationship, and moreover, X and Y sometimes cooperated by working with each other and traveling together.

X and Y lived separately and did not cohabit. They were economically independent and did not own common property.

According to the prior mutual decisions of X and Y, which were based on the wishes of X to avoid the burden of raising children, X had nothing at all to do with raising the two children, and at the time of their births, X received considerable monetary compensation from Y.

X and Y repeated that they gave a notification of the birth with a notification of the marriage at the same time as the birth, and gave a notification of a divorce by agreement just after that, because they were concerned about the disadvantages in law for illegitimate children. Moreover, there were no agreements between X and Y regarding their intentions to marry under Civil Law, after ending their engagement in March 1986, and rather, X and Y had been evading marriage on purpose.

There was no evidence in X and Y's relationship of having reached an agreement to continue their relationship by which the other must not leave the relationship by marriage, or so on, with another person without the consent of the other.

"Needless to say there is no scope to recognize a guarantee of the continuation of the relationship in the same way as a marriage. Therefore it cannot be said that Y has some legal obligations to X, nor does X have any legal rights or interests concerning the

continuation of the relationship. Hence, the act could not be seen to be an unlawful act from which a right to compensation for pain and suffering could originate, on the grounds that Y had suddenly and unilaterally ended the relationship with X, which had continued for many years, and married another woman.”

[Commentary]

In this case, the issue is whether the person concerned whose relationship between a man and a woman outside of marriage is dissolved suddenly and unilaterally, despite continuing for a long period, is able to claim liability for an unlawful act from the one who dissolved the relationship. Although in reality there are various kinds of relationships between men and women such as in this case, what kind of relationship becomes an object of legal relief in the case of unreasonable dissolution? In 1915, the Great Court of Cassation considered a certain relationship outside of marriage as a “reservation of marriage”, and held that a person who unjustly cancels this ‘reservation’ without legitimate reason is liable for the payment of damages for non-performance of an obligation (Great Court of Cassation January 26, 1915 Judgments; Min-Roku No. 21 p. 49). This precedent makes the unfair cancellation of various relationships in the process of a formation of marriage subject to legal relief.

One form of relationship outside of marriage is the de facto marriage. The precedent and the prevailing theory attach great importance to the existence of joint living (cohabitation) for a de facto marriage relationship. A de facto marriage is assumed to be a relationship which is consistent with a marriage (a relationship of quasi-marriage) and is given legal protection (Supreme Court, April 1, 1958 Judgments; *Min-shū* Vol. 12, No. 5. p. 789).

However, it is difficult to consider the easy application of this de facto marriage protection principle to this judgment. There was no process of X insisting on the formation of a common-law marriage. In addition, this relationship has limited scope for legal protection because X and Y were economically independent of each other and the substance of their cohabitation as a requisite for a common-law marriage was also weak. Based on the facts, it can be seen that X and Y lacked the intention to marry. The rules of the relationship were made by agreement between X and Y. It can be said that the relationship between X and Y was formed by their intention to refuse the protection afforded by legal marriage (although they made notification of their marriage in consideration of the children at the time of birth as a matter of convenience); the relationship lacks the substance of a de facto marriage, and was a relationship in which the parties did not select legal marriage consciously nor did they want the legal effect of a marriage in law. The strong opinion of Prof. Noriko Mizuno is to deny legal protection on the grounds of the theory of quasi-marriage and to attempt to provide protection to the parties using contract theory, establishing the intention of the parties an important element.

The Tokyo High Court held that the process of dissolution of the relationship between X and Y betrayed the expectation of the continuation of the relationship, and raises logical legal constitution as an important factor in identifying the responsibility of an unlawful act. However, it can be said that the characteristic of the Supreme Court judgment is rather to give a comprehensive judgment from two perspectives. According to the Supreme Court, these are the intentions of the parties (facts and given in this judgment, above) and the substance of cohabitation (facts, and). In addition, from the substance of their cohabitation, it is possible to suppose the lifestyle that X and Y wanted. Even if the independent relationship by agreement between a man and a woman out of marriage is to be respected as much as possible from the viewpoint of contract theory, there may, however, be some illegality from the point of view of public order and good morals concerning the intention in the agreement regarding the birth of children and the extreme apathy of X in relation to raising children, as shown in facts in the judgment.

I think that there are many elements of this case which make it an important precedent. Given the social trends towards relationships outside of marriage in which people choose lifestyles based on their free will, and the growing diversification of relationships, I believe it will have a significant influence on future practice with regard to the scope of legal protections for a couple's relationship outside of marriage.

(SASAKI Takeshi)

Case Concerning Taxation of Profits from the Exercise of Stock Options

(Supreme Court, P. B. 3; January 25, 2005; *Hanrei-jihō*, No. 1886, p. 18)

Keywords : Stock Option, Employment Income, Occasional Income

[Facts]

The plaintiff in this case, 'X', was a corporate officer of Company A incorporated in Japan. Company A was a subsidiary of Company B incorporated in the United States. X was given stock options by Company B.

A stock option is a right given by a company to directors or employees of that company to acquire a certain number of shares of the company's stock at a fixed price, called the 'strike price', within a fixed period of time. When the price of the company's stock rises, the directors and/or employees who have been given stock options can exercise this right to purchase stock at the strike price. If the stock thus acquired is sold immediately, the difference between the current market price and the strike price of the stock means a profit for the person who exercises the stock option.

The Fundamental Income Tax Interpretive Regulations (*shotokuzeikihontsūtatsuno kitei*) issued in 1996 state that, in principle, income derived from the exercise of stock

options are to be considered occasional income. However, in 1998, the Tax Bureau implemented a policy by which the difference between the value of the stock sold at the current market price and their value when purchased at the strike price would be regarded as employment income for tax purposes.

The plaintiff in this case, X, exercised his stock options to acquire common stock of Company B, which he then sold immediately to realize 360 million yen profits from 1996 to 1998. In filing his tax return, X classified this profit as occasional income.

However, the Superintendent of the Taxation Office, 'Y', decided that this income was in fact employment income. He therefore decided to reassess X's taxes and levied a penalty for underpayment.

X then filed a claim against Y arguing the following three points.

- This income was derived from fluctuations in the price of the stock, and is unreliable. Moreover, it cannot be said that this income is of the same nature as income derived as remuneration for labor. As the amount of income may vary according to the price of the stock at the time stock option is exercised, it is appropriate to treat this as occasional income.
- X does not have an employment contract with Company B nor any similar agreement, and therefore, the profit derived from the exercise of stock options does not correspond to employment income.
- For more than 10 years, the Tax Bureau, including Y, had instructed taxpayers to classify income of this type as occasional income. X had relied on these instructions in filing his tax return. Therefore, reclassifying such income as employment income constitutes a breach of the principle of good faith.

In the first instance, the Tokyo District Court accepted X's claim for the following reasons:

- Profits obtained through the exercise of stock options are not remuneration for services rendered; rather, they are incidental income derived from using one's judgment to make an investment. They are not related to labor; but are related to assets. Moreover, this type of income is not necessarily generated repeatedly. The reassessment of this income as employment income is therefore not legitimate, and the penalty for underpayment which was based on this reassessment is also illegal.
- The defendant, Y, argued that even if the profits from the exercise of stock options are not considered employment income, they should be classified as miscellaneous income, and therefore the plaintiff's declaration of income still should nevertheless be considered incorrect. However, the Court stressed that such an interpretation is also based on the view of these profits as remuneration for services rendered and is therefore also mistaken.
- The Court concluded that profits obtained through the exercise of stock options are neither employment income nor miscellaneous income, and that therefore they should

be classified as occasional income for tax purposes.

However, in the second instance, the Tokyo High Court overruled the Tokyo District Court's judgment and accepted Y's claim for the following reasons:

- The profits from the exercise of stock options involve the economic value of the upturn in stock price being transferred to X from Company B.
- Considering the purpose for which the stock option was given, and the conditions for the exercise of the stock option, the profits should be deemed as remuneration for services X provides to Company A under Company B's directions.
- The amount of the profits from the exercise of stock options is dependent on the fluctuations in stock prices after the granting of the stock option, and are determined at the time X decides to exercise his right. Therefore, for the above reasons, the profits cannot be deemed occasional income.

X appealed this decision to the Supreme Court.

[Judgment]

The Supreme Court dismissed the final appeal for the following reasons:

"In this case, only the person to whom the stock option was given can exercise the stock options right, and that person cannot then transfer or assign the right. Therefore, the person will not receive economic profits without exercising that right. If this is the case, it can be said that by providing the stock options in accordance with the contract, and by allowing the acquisition of stocks at a certain strike price, Company B in fact provided the appellant those profits from the exercise of the stock options. Therefore, these profits should be deemed to be a benefit provided by Company B to the appellant. Although the amount of the profits from the exercise of stock options are dependent on the fluctuations in stock price after the grant of the stock option, and are determined at the time X decides to exercise his right, for the reasons outlined above, it cannot be denied that these profits in fact constitute a benefit provided by Company B to the appellant."

"Note that these profits were received from Company B, and not from Company A, of which the appellant was a corporate officer. However, as Company B is the parent company of Company A, with 100% of the issued stocks, Company B is deemed to be capable of controlling matters such as personnel management with regard to corporate officers. Therefore, the appellant was carrying out the role as a corporate officer of Company A under the supervision of Company B. Additionally, this stock option system was established so as to encourage regular attendance from the officers and employees of the Company B group. It is thus apparent, that as the appellant was carrying out the job as stated above, a contract was concluded between Company B and the appellant based on this stock option system, and the stock option was given to the appellant. Therefore, these profits from the exercise of stock options are economic earnings that constitute remuneration to the appellant for having carried out the job as stated above. If this is the case, these profits from the exercise of stock options are employment income under the

Individual Income Tax Act, Article 28 (1), as these profits constitute remuneration for subordinate labor based on an employment relationship."

[Commentary]

The issue in this case is whether the profits obtained through exercising stock options constitute employment income, occasional income, or miscellaneous income. Employment income, occasional income, and miscellaneous income are defined in the income tax law as follows:

- (1) **Employment income:** Employment income shall mean income pertaining to salary, pay, wages, yearly allowances and bonuses, as well as earnings of a similar nature (Individual Income Tax Act, Article 28).
- (2) **Occasional income:** Occasional income shall mean income other than interest income, dividend income, real estate income, business income, employment income, retirement income, forestry income or capital gain, which is temporary in nature and which is not accrued from continuous action for the purpose of profit-making, nor considered as remuneration for services such as labor or for the transfer of assets (Individual Income Tax Act, Article 34).
- (3) **Miscellaneous income:** Miscellaneous income shall mean income not falling into the categories of interest income, dividend income, real estate income, business income, employment income, retirement income, timber income, capital gain or occasional income (Individual Income Tax Act, Article 35).

On April 24, 1981, the Supreme Court defined employment income as follows:
"Employment income is the payment which employees receive from employer under the following conditions:

- There is an employment contract, or a similar agreement.
- Employees follow the employer's directions.
- The payment which the laborers receive from the employer is remuneration for services the employees provide to the employer."

We can therefore conclude the following regarding the profits gained through the exercise of stock options:

- If there is an employment relationship, the profits will be considered employment income.
- If there is no employment relationship and the profits are regarded as remuneration for services rendered, it will be considered miscellaneous income.
- If there is no employment relationship and the profits are regarded as remuneration for services rendered, profits will be regarded as occasional income.

The Tokyo District Court which heard this case determined that where there was no employment relationship, and the profits derived from the exercise of stock options does not constitute remuneration for services rendered. Therefore, the profits derived from the exercise of stock options should be classified as occasional income for tax purposes.

However, the Tokyo High Court which heard this case determined that there was an employment relationship, and that the profits derived from the exercise of stock options should be classified as employment income for tax purposes. The Supreme Court affirmed this decision in the judgment of this case. The outcome is significant for the evolving field of corporate governance in Japan.

(YASUI Eiji)

Livedoor Co./Nippon Broadcasting System Inc.—To Prohibit the Issue of New Stock Options

(Tokyo High Court, March 23, 2005; *Hanrei-jihō*, No. 1899, p. 56)

Keywords : Takeover Bid, New Stock Options, Corporate Value

[Facts]

On February 8, 2005, Internet firm Livedoor Co. raised its stake in Nippon Broadcasting System Inc. (NBS) to about 35 percent of all outstanding stocks by ToSTNet-1. NBS and Fuji Television Network Inc. (Fuji TV) are members of Fujisankei Communications Group. Fuji TV, which was in the process of carrying out a takeover bid (TOB) to make NBS a subsidiary company, objected to this move by Livedoor, and on February 10, Fuji TV announced that it would reduce the stock acquisition target for its TOB of NBS to 25%. Relying on Article 241 (3) of the Commercial Code (see also Article 308 (1) of the Corporate Law), this move was aimed at preventing Livedoor from exercising indirect control over Fuji TV by way of extinguishing Fuji TV's voting rights with regard to NBS.

Furthermore, on February 23, NBS announced that it would issue about 40 million new stock options in favour of Fuji TV. Exercising these stock options could weaken the influence of Livedoor on NBS, and effectively allow Fuji TV to make NBS a subsidiary. In response to this, Livedoor applied for a provisional disposition on the issuance of new stock options, relying on the Commercial Code, Articles 280 (39) (4) and 280 (10) (see also Article 247 of the Corporate Law)—“significantly unfair methods”—stating that it would prejudice existing shareholdings.

The Tokyo District Court held in favor of Livedoor, and on March 11, it ordered a provisional disposition on the issuance of new stock options. The basis for this decision was as follows: where a dispute arises over the control of a company, and where the main purpose of the issuance of new stock options is to decrease the stock ratio of a certain stockholder, and to maintain control of the existing management regime, then it shall be deemed an unfair issuance “insofar as there are no special circumstances which justify the issuance of new stock options from the perspective of protecting the company, and in turn,

all of the stockholders". Although it cannot be said that the actions in this case are concerned with maintaining the position of the existing directors, its main purpose is "aimed at maintaining control over the existing management regime, which is essentially the management that was under the control of the Fujisankei Communications Group". Accordingly, in order to justify the issuance of new stock options as a measure to prevent damages to the corporate value, it must be shown that "the corporate value will be significantly damaged if control is acquired by a certain stockholder". This has not been sufficiently proven in this case.

On the same day, NBS applied for a preservation objection (*hozen-igi*). However, on March 16, the Tokyo District Court reached the same conclusion and upheld the decision to issue a provisional injunction. NBS filed an objection and appealed to the Tokyo High Court.

[Judgment]

On March 23, the Tokyo High Court affirmed the decision of Tokyo District Court and dismissed the preservation objection for the following reasons:

(1) The general authority of directors to issue new stocks/new stock options

"Financing business plans, establishing business collaborations with other industries, and cross-ownership of stock to maintain a business relationship based on trust have all long been the province of the general authority of directors. Where new stock has been issued to a third party based on management decisions that are both necessary and reasonable, it is generally accepted that a stockholder's stock ratio will thereby decrease. When a dispute arises regarding the management control of a company, and the Board of Directors decreases the stock ratio of certain stockholder (who is attempting to gain control) by issuing new stock for the main purpose of maintaining/securing control over management by a certain stockholder, who has actual influence and supports the existing management, this general authority of management judgment exercised by the Board of Directors is not unlimited."

(2) Principled judgment standard of an unfair issuance

"Where a dispute arises over the control of the management of a company, and new stock options have been issued for the main purpose of maintaining/securing the control over management by a certain stockholder, who has actual influence and supports the existing management, and as a consequence, the stock ratio of the certain stockholder who is attempting to gain control by way of hostile takeover decreases, in principle this constitutes an issuance of new stock options by way of a 'significantly unfair method'."

(3) Special circumstances justifying the issuance of new stock options with the purpose of maintaining control over the company and the judgment method

Examples of business judgment and special circumstances justifying the issuance of new stock options are as follows:

1. "When the purchaser is procuring stock simply to raise the stock price, notwithstanding the absence of an intention to participate in the management of a company, and thus to cause trading amongst those parties associated with the company at an high price (in cases of so-called 'green mailers');
2. When the purchaser is procuring stock to transfer necessary intellectual property rights, know-how, confidential corporate information, main trading partners and clients to itself or its group of companies, after temporarily influencing the management of the company, and to implement a strategy of running the business into the ground;
3. When the purchaser is procuring stock to misappropriate the assets of the company as security or repayment funds for debts of the purchaser or its group of companies, after having influenced the management of the company;
4. When the purchaser, after temporarily influencing the management of the company, is procuring stock to sell off high-priced assets unrelated to the present business activities of the company, and then to use the profits from the disposal of the assets to create temporarily high dividends, or to use the sudden rise in the stock prices that comes from those temporarily high dividends as an opportunity to sell the stocks at a high price."

"When it can be proven *prima facie* by the company that the hostile takeover bidder is not seeking to seriously and rationally manage the company, and the circumstances are such that damage will be inflicted in a way that it will be difficult to revive the company."

[Commentary]

This incident became the subject of national interest through reports in newspapers, news broadcasts and the like. As Japan has entered an era in which it is forced to face the prospect of hostile takeovers, the need has become apparent for a variety of legal mechanisms with regards to mergers and acquisitions (M&A), such as injunctions against the issuance of new stock options.

The part of this judgment that addresses the "significantly unfair method" component of the decision to order an injunction on the issuance of new stock options conforms with the existing case law and academic theories. The "significantly unfair method" requirement for an injunction on new stock option issuance concerns those instance where there is a dispute over the right to control the management of a company, and the Board of Directors issues new stocks to maintain a majority in terms of voting rights.

The Tokyo High Court identified four types of special circumstances that would deny the unfair issuance of stock, each of which were indicated to be of the type of highly problematic hostile takeovers in the USA. In addition, "insofar as the Board of Directors acknowledges the defensive measures as being necessary and reasonable", they are permitted to issue new stock options for the main purpose of maintaining/securing control.

With regard to hostile takeovers falling within any of the four above-mentioned categories, the acceptability of issuing new stock options for the main purpose of maintaining/securing control is not unconditional. Here we see the influence of the so-called *Unocal* Standard under Delaware corporate law. However, it is necessary to further debate this, as the Standard gives no particular indication as to what extent opposing measures can be employed against various types of hostile takeover.

In light of the Business Judgment Rule, this case is not one in which the court can judge what type of proposal will increase corporate value. Moreover, although it is ultimately a matter to be decided by the stockholders, it remains unclear specifically as to what corporate value is, and how it is to be measured.

In any case, this incident presented an opportunity to revise the legal mechanisms regarding M&A. On May 27, 2005, the Ministry of Justice together with the Ministry of Economy, Trade and Industry devised "Ensuring and/or increasing corporate value and stakeholder profits: takeover defense guidelines", and on the same day, the Corporate Value Study group released its "Corporate Value Report" (Available online at <http://www.meti.go.jp/english/information/downloadfiles/Corporate%20Value.pdf>). Thus, the legal groundwork for M&As are still in a state of development.

Finally, NBS retracted its appeal to the Supreme Court and abided by the District Court's decision to issue an injunction. Following this, a Memorandum of Understanding outlining Fuji TV's capital investment in Livedoor, and other such business collaborations, was concluded and the matter was settled.

(MURAKAMI Koji)