Bond Law Review

Volume 5 | Issue 2 Article 8

1993

A Study of Judicial Precedents in Commercial Law: Liability of a Limited Liability Company Director to a Third Party for Trading and Issuing Notes After Deterioration of the Business and Bankruptcy of the Company

Takamoto Suzuki

A Study of Judicial Precedents in Commercial Law: Liability of a Limited Liability Company Director to a Third Party for Trading and Issuing Notes After Deterioration of the Business and Bankruptcy of the Company

Abstract

[extract] The liability of a director of a Limited Liability Company to a third party (under Yugen Kaisha Ho, Article 30-3) should be applied consistently with the interpretation of Commercial Code, Article 266-3 in spite of the fact that there are minor variations because of the special nature of Limited Liability Companies.

In this decision, in which the breach of a representative director's duty to supervise was questioned, the immediate issue was that the neglect of duty by the director taking the action (it is unclear from the judgment whether B became a representative director before or after these transactions and note issuances) was based on bad faith and gross negligence.

Keywords

commercial law, business judgment rule, liability of directors, Japan

A STUDY OF JUDICIAL PRECEDENTS IN COMMERCIAL LAW: LIABILITY OF A LIMITED LIABILITY COMPANY DIRECTOR TO A THIRD PARTY FOR TRADING AND ISSUING NOTES AFTER DETERIORATION OF THE BUSINESS AND BANKRUPTCY OF THE COMPANY

Shoji Homu (No. 1298) 29 - 32 (15 September 1992)

by
Takamoto Suzuki

Analysing the 28/2/1989 Decision of the Tokyo High Court Originally Reported in Hanrei Times (No. 723) 243.

Translated by Adam Cottrell and Hiro Yamada in completion of the requirements of the Japanese Legal Translation subject at Bond University, supervised by Assistant Professor Vicki Beyer.[*]

A Company was established in 1969 as a limited liability company[TN] with 5 million Yen capital. Its stated purpose was processing and sale of metallic die castings. In order to facilitate B's (Y's second son) management of A Company, Y (Defendant, Appellant, Counter-Appellee) provided 3 million Yen of the company's capital. Because of B's young age, Y became representative director of the company, while B was given a position as a director. Nonetheless, Y entrusted B with the management of A Company. Later, in about 1984, B joined Y as a representative director; this fact was duly registered.

Sometime after that, and also in 1984, A Company began to receive orders from C Company for slot machine parts. B having learned from the president of C Company that the slot machine regulations were about to be

---

* (TN in the footnotes refers to Translators' Note).

TN The Limited Liability Company, in Japanese Yugen Kaisha, is governed by the Yugen Kaisha Ho (Limited Liability Company Law), which was enacted in 1938. Conceptually it is based on the German Gessellschaft mit beschrankter aftung (GmbH). This type of company is designed for small enterprises who do not intend to go public with their shares. Only one director and a minimum capital of 5 million yen is required.

amended and that expanded production requirements would result, expanded the factory and the range of slot machines produced. However, amendment of the slot machine regulations was postponed and, because the possibility arose that after the amendment the overall design of slot machines would be standardised, C Company reduced the number of orders it placed with A Company. As a result the financially strapped A Company went into bankruptcy on 10 December 1984.

X Company (Plaintiff, Appellee, Counter-Appellant) has supplied and sold manufacturing materials to A Company since before 1978. X Company carried out the transactions at issue in this case between 11 June and 31 October 1984. In order to pay X Company, A Company issued six promissory notes (the notes at issue in this case) each with a due date six months after the date of issue (the notes were issued by B). However, the bills were dishonoured due to A Company's deterioration and bankruptcy. X Company alleges that Y is liable, as a representative director, for breach of his duty to supervise because:

(i) A Company's bankruptcy was caused by B's loose management and failure of business judgment.

(ii) at the commencement of each transaction, B was fraudulent in both words and actions.

(iii) B entered each transaction with no intention or reasonable expectation of paying the notes. Such reckless conduct constituted bad faith and gross negligence.

X Company claims damages equivalent to the face value of the promissory notes. X's claim against Y, which is based on B's neglect of duty through bad faith and gross negligence, was dismissed by [the High Court], which found as follows:

Findings

(i) Until around August 1984 the management of A Company was sound. At that time B expanded the factory and planned to increase parts production expecting an expansion in demand for slot machines, based on the conditions described in the above findings. In light of those circumstances and conditions, it cannot be said B's decisions were completely reckless and irrational. Nor can it be said that they caused damage to the company's creditors. Therefore, even if the result of the plan to increase production can be evaluated as a failed management decision as alleged by X... it cannot be said that the bankruptcy of A Company was due to bad faith and gross negligence on the part of B.

(ii) About 1979 X recognised that even though Y was the representative director of the company, B essentially conducted the management of A Company. Since X continued to conduct transactions with A Company after that, even if B's words and actions were as alleged by X at this time and thereafter, it cannot be said that B had bad faith and gross negligence as regards the transactions in question.

(iii) Although the business circumstances of the company had deteriorated, the management put in place financial funding and other arrangements to rebuild the operation. Because it is only natural to wish to continue the business, looking at that one act even after the business circumstances of the company had deteriorated, it cannot be said that the director's actions in issuing notes and conducting transactions after that time... is a breach of the director's duties.

It must be said that as long as there are no particular circumstances which are blatantly irrational at the time of the act, such as acts calculated to cause profit to a director personally or loss to a third party, it cannot be said that there has been a breach of duty by said director.

Applying this to the present case, ... there is not sufficient evidence to show particular circumstances such as those mentioned above; ie, that B carried out the transactions and issued the notes in a manner calculated to cause profit to himself or loss to a third party.

(iv) Due to the above reasoning, X's allegation that A Company"s bankruptcy and each transaction and note issue were caused by B's bad faith and gross negligence cannot be accepted.

Analysis

(i) The liability of a director of a Limited Liability Company to a third party (under Yugen Kaisha Ho, Article 30-3) should be applied consistently with the interpretation of Commercial Code, Article 266-3 in spite of the fact that there are minor variations because of the special nature of Limited Liability Companies.[1]

In this decision, in which the breach of a representative director's duty to supervise was questioned, the immediate issue was that the neglect of duty by the director taking the action (it is unclear from the judgment whether B became a representative director before or after these transactions and note issuances) was based on bad faith and gross negligence.

1 Tatsuta, *Kaisha Ho Review*, New ed, Vol 14 at 239.

The issues raised are:

(a) bankruptcy of the company due to poor management and a failure of business judgment;
(b) fraudulent trading;
(c) conducting transactions and issuing notes without expectation of payment.[2]

(ii) Concerning the first issue, B's judgment to increase production of slot machine parts, the finding logically concludes that B did not neglect his duty in bad faith and with gross negligence; the decision was neither imprudent nor irrational, even though it resulted in failure. In this section, it seems that the so-called business judgment rule has been applied. The principle of the business judgment rule is 'the director conducts business in a sincere manner, as an entrepreneur, within the limits of rational choices; even if the action taken is consequently incorrect, unsuccessful and results in damage to the company, the director cannot be held liable on the basis of a breach of the duty of care.'[3]

For sometime now, the business judgment rule has been asserted as an academic theory;[4] there are some instances in which it has also been applied in precedents. For instance, the 25 November 1986 decision of the Osaka High Court,[5] is a precedent in which the liability of a representative director was at issue when the company was forced to seek corporate reorganisation following the bankruptcy of a subcontractor who had received a financial loan from the company.

The precedent stated:

> When a director decides on the company's managing principles and policy, it is only natural to expect his actions to be accompanied by a reasonable degree of risk. Therefore, it does not reflect the true condition of corporate management to expect a director to be legally accountable as if there was neglect of duty to the company in the event that his actions, based on his previous knowledge, experience and rational calculations initiating a policy for the company which is natural and predictable from a managerial perspective, should result in failure.[6]

---

2 For further annotations on this case, refer to Hayashi, Kinsho (No 843) 51, Kakiuchi, Hanrei Times (No 735) 268 (commentary on Major Civil Precedents 1989).

3 Kanzaki, *A Treatise on the Director System* at 83.

4 Eg. Osakaya, *Director Liabilities*, Lectures on Stock Corporation Law Vol 3, 1119 ff Kanzaki n 3 above at 83 ff. Kondo, *Director Liabilities and Their Remedies* Pt 4, 99:12 Hokyo at 30 ff.

5 Hanrei Jiho (No 1229) 144.

6 Other cases which have applied the business judgment rule are: Sendai District Court 7 September 1977, Hanrei Jiho (No 893) 90; Tokyo District Court 2 March 1978 Hanrei Jiho (No 909) 95; Tokyo District Court 30 September 1980 32:5-8 Minshu 722; Osaka District Court 28 October 1983, Hanrei Times (No 513) 174.

However, as a theoretical matter, a question is raised about the application of the business judgment rule to a director's liability to a third party. Originally this rule takes into account the director's position in a company, as a trustee of the shareholders, given that in companies ownership and management are separated. It is a precondition that the rule be applied in case a director's liability to the company is questioned.[7] Furthermore, many of the precedents in which the business judgment rule appears to have been applied simply confirm the doctrine of liability for neglect[8] although they also show some appreciation of the director's business judgement.[9] Also it cannot be said that the business judgment rule as raised in the precedents is consistent; it may need further annotation.

At any rate, the attitude that liability does not necessarily occur when a rationally made business judgment results in failure, does not exclude the question of whether the director's judgment was negligent. While it is only natural to wish to facilitate the director carrying out his duty of care, the business judgment rule should not unnecessarily relax the director's duty of care. Considering a director's managerial negligence, even if distinctive characteristics such as the director's specialisation or the risk involved are taken into account, these should be considered under tort liability since they also occur widely among professional occupations other than directors.[10] The interpretation of this judgment that 'a manager's judgment which is totally imprudent and irrational clearly causes damage to the company's creditors', should be used as a standard of judgment for whether there has been a breach of the duty of care based on bad faith and gross negligence. However, there is room to question whether this standard of judgment can be adapted to the previously recognised content of the director's duty of care.

(iii) This judgment made it clear that conducting transactions and issuing notes after the deterioration of management does not naturally constitute director's breach of duty; we should consider this correct.

However, on the other hand, particularly cautious judgment is required for a director conducting transactions and issuing notes when the company's financial situation is deteriorating. The Urawa District Court[11] found that a director had neglected his duty when he continued

7 Kondo, *Director Liability to Third Parties Based on Commercial Code* 266-3 (1) and *The Principle of Business Judgment* Minsho 88:5 577; cf Morimoto, Hanrei Hyoron, No 279) 39.

8 Kawahama, *Examination of Business Judgment Rule in the US*, Pt 2, 114:5 Hogaku Ronso 59.

9 Kondo n 4 above Hokyo Ronbun, 38.

10 Kondo n 7 above Minsho Ronbun, 601.

11 28 February 1985 Hanrei Jiho (No 1159), 154.

the business even though he was well aware of the financial situation. It found that he took things too easily, engaging in 'bicycle operations', keeping the organisation in continuous operation to keep it from collapsing in the same manner as a bicycle must be kept in continuous motion to keep it from collapsing. He apparently thought things would improve or change as long as he kept the business operating.[12] It seems that we can question the value of the instant judgment since it can be thought that rather than making an effort to rebuild the company's business, B simply continued to increase production of slot machines, believing conditions would change for the better.

Even if it can be said that a director's breach of duty does not occur as a result of simply conducting transactions after the deterioration of the business, in many cases, director liability for the company's burden of debt has been determined based on whether or not there is an expectation of payment. However, the judicial precedents are unclear as to the circumstances in which it can be said that there is no expectation of payment. As an extreme example, there is a precedent which could be read as precluding issuing notes when finances are deteriorating. It says:

> [the company's] finances were understood to have become extremely bad; therefore, it should be said that there was a great fear that had the promissory notes been issued, they could not be paid upon maturity at such a time..., even if the notes were issued with the expectation that payment would be made on maturity.., we have to say that the act of issuing them was grossly negligent.[13]

The instant judgment mentioned that transactions and note issuances after deterioration of the financial situation is not a neglect of duty unless there are special conditions which are recognised as being remarkably irrational.[14] Is there not a distinction between the two precedents concerning the elements of the director's duty of care: one found that due to the deterioration of the company's finances there was no expectation of payment at the time of the transaction; the other held that neglect of duty was not applicable unless there were special circumstances, such as irrationality? The decision in this case establishes a standard of irrationality[TN] for transactions and notes issuances when there is no possibility of payment as compared with

12 A similar example is the Nagoya District Court 12 April 1991 (Hanrei Jiho (No 1408) 119).

13 Osaka High Court 29 December 1978 Kinpo (No 906) 39.

14 For similar judgments such as: n 6, Tokyo District Court 30 September 1980; Tokyo District Court 30 September 1982; Tokyo District Court 2 March 1978 Hanrei Jiho (No 909) 95; Osaka District Court 18 November 1980 Hanrei Times (No 437) 158.

TN Standard of irrationality maintains that special circumstances, such as irrationality, are prima facie neglect of duty, although the absence of irrationality does not prove that there has been no neglect of duty.

previous cases which seem to be relaxing the duty of care. However, the next question must be what is the reason for relaxing the duty of care. If this decision takes the attitude of negating the director's liability by adopting the business judgment rule even for transactions and note issuances after deterioration of the business, the point raised in Analysis item (ii) again comes to a head.

(iv) In the present case, although a breach of Y's duty as a representative director to supervise has been alleged, the issue is the neglect of duty by another representative director, B, who was operating the business. In the event that, as regards the actor, liability under Commercial Code Article 266-3[15] does not arise, the breach of another director's duty to supervise is also not a problem. This is because, it is only natural that the other director should not be liable to third parties under that section.[16] Regarding this reasoning, precedent has explained that although there has been bad faith and gross negligence regarding the neglect of duty by a director who bears a duty to supervise, there is no causative relationship with the damages.[17] However, the explanation in this judgment by the Supreme Court has been questioned. Is it not more natural to think that because there has been no illegal act by the person who acts, the absence of effort by the director with a duty to supervise to obstruct the illegal act of the person acting cannot, vis a vis third parties, be considered an illegal act.[18]

At this time it is not entirely clear, in negating liability for breach of the duty to supervise, whether it is sufficient that there was no bad faith or gross negligence in the neglect of duty or whether it is necessary that there was no neglect of duty at all. While this judgment found that there had been no neglect of duty based on bad faith or gross negligence as regards B, the attitude on this point is not clear, since the court also found that there was no reason to claim against Y because ultimately it could not find 'evidence of B's neglect of duty'. On the other hand, the above-cited 1970 Supreme Court decision commented as regards neglect of duty which is premised on negating liability for breach of the duty to supervise that 'the requisite for director liability to third parties is lacking'. Accordingly, it seems that breach of the duty to supervise becomes a problem only when a person acts in bad faith or with gross negligence. However, if we follow the reasoning of the 1969 judgment of the Grand Bench of the Supreme Court[19] which considered that bad faith and gross negligence were indispensable conditions for neglect of duty to the company, in

15 In the present case, Yugen Kaisha Ho Article 30-3.

16 Osumi and Imai *Review of Company Law*, New Ed Vol 2-1 at 242.

17 Supreme Court decision of 16 July 1970, 24:7 Minshu 1061.

18 Ueyanagi, *Merger of Both Responsibilities [lit. damages] Theory*, 102:4/5 Hogaku Ronso 1 ff)?

19 Supreme Court decision of 26 November 1969, 23:11 Minshu 2150.

the event that damages arise to a third party for neglect of duty and there has been no bad faith or gross negligence, could we take the approach that another director will be liable due to breach of the duty to supervise based on bad faith and gross negligence? If this is true, the relationship between neglect of duty by a person who has acted and breach of the duty to supervise by another director presents a problem which inevitably needs to be further examined.