Bond Law Review

Volume 5 | Issue 2 Article 5

1993

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Abstract
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Keywords
Japan, business judgment rule, duties of directors

JUDICIAL DEVELOPMENT OF A BUSINESS JUDGMENT RULE IN JAPAN

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Wherever the law allows for the creation of a company, the law also creates duties which those operating the company owe to those financing it. These duties constitute a set of expectations vis-a-vis the job performance of the directors of the company. Broadly speaking the duties are the same in most jurisdictions: 'to act lawfully, to act loyally and to act carefully'.[1] The parameters of the duties vary between jurisdictions, however, as each is interpreted by the courts of that jurisdiction in light of its legislation and judicial precedents. In spite of these differences, where one jurisdiction has developed a workable approach to some aspect of directors' duties, it is worthwhile to consider the adaptability of that approach in other jurisdictions.

In 1992 the *Bond Law Review* published an essay by Professor Deborah DeMott[2] that considered the development of the business judgment rule in the United State of America and raised some of the difficulties to be encountered if Australia were to apply a similar rule. Professor DeMott suggested that the statutory structures in the two jurisdictions were sufficiently different to make the adoption of the American business judgment rule in Australia questionable.

The business judgment rule as discussed by DeMott embodies the notion that directors know the situation better than judges attempting to make an after-the-fact examination. Essentially it is a 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company'.[3] If this presumption is not rebutted by the plaintiff, the court will accept that the judgment of the directors at the time made, irrespective of the ultimate outcome, was appropriate under the circumstances.

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1 See DA DeMott, 'Directors' Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices', (1992) 4 Bond LR 133, citing Eisenberg, 'The Duty of Care of Corporate Directors and Officers, (1990) 51 U Pitt L Rev 945.

2 Above n 1.

3 *Smith v Van Gorkom* (1985) 488 A2d 858, 872 (Del) citing *Aronson v Lewis* (1984) 473 A2d 805, 812 (Del). Note that this characterisation of the rule differs slightly from that enunciated by the American Law Institute, which requires a rational belief, rather than an honest belief in the third prong of the test.

This article examines the application of a business judgment rule in Japan, a civil law jurisdiction with a statutory scheme that is different from that of either the United States of America or Australia. As will be seen, in spite of these differences, a business judgment rule similar to that in the United States of America appears to be developing.

Director's Duties In Japan

Professor Misao Tatsuta, a leading Japanese corporation law scholar, identifies two basic duties of corporate directors: the duty of loyalty and the duty of care.[4] In addition to these, the Commercial Code[5] also contains three other duties of directors: a duty to monitor other directors,[6] a duty to ensure funds for interim dividend disbursal[7] and a duty to third parties.[8] The duty of loyalty, established by Commercial Code Article 254-3, requires the director to 'discharge his duties faithfully in the best interests of the corporation'. Other statutorily created duties which are considered to be a part of the duty of loyalty include a duty to avoid competing with the corporation[9] and a duty to avoid conflicts of interest.[10] The duty of care is derived from Commercial Code Article 254(3), which states that 'the relationship between a corporation and its directors is governed by the provisions on agency'. The provisions on agency[11] essentially require the director to 'manage the affairs entrusted to him with the care of a good manager'.[12]

Although there are no statutory provisions which specifically limit application of these duties where business decisions have been taken, over the past two decades a number of judicial decisions have been reached which purport to apply a 'business judgment rule' (keiei handan kisoku) to

4 Misao Tatsuta, *Kaisha-ho* (Company Law) 2d ed (1991) Tokyo: Yuhikaku at 86.

5 *Sho-ho* (Law No 48, 1899).

6 Commercial Code Article 260(1): 'The board of directors shall manage the business and affairs of the corporation and shall supervise the job performance of the directors'.

7 Commercial Code Article 293-5 (Interim Dividends) provides in paragraph 5: 'If the corporation's net assets at the end of the current fiscal year are in fact less than the amounts described in article 290(1), items (1)-(4) on that date, the directors who assented to the cash dividend described in paragraph 1 are jointly and severally liable for damage to the corporation...'

8 Commercial Code Article 266-3: 'A director is jointly and severally liable for damages to a third party resulting from bad faith or gross negligence in the performance of his or her duties as a director'.

9 Commercial Code Article 264(1): 'A director who intends to undertake a transaction within the scope of the corporation's business purpose for the director's own, or a third party's, behalf, must disclose to the board of directors all material facts relating to the proposed transaction, and must obtain the approval of the board of directors'.

10 Commercial Code Article 265(1): 'A director must obtain the approval of the board of directors for any proposed transaction with the corporation by which the director will purchase corporate property from the corporation, sell to the corporation property he owns, or will borrow money from the corporation, or for any other transaction with the corporation undertaken for the director's, or a third party's, behalf'.

11 See *Minpo* (Civil Code, Law No 89, 1896), Articles 643 through 656.

12 Civil Code Art 644..

precisely that end.

These decisions and the nature of the rule they espouse, are necessarily shaped by the relevance and power of judicial decisions in the Japanese legal system.

Role of judicial decisions in Japanese law

As a civil law system, Japan's principal source of law is its statutes. The job of the courts is to interpret the statutes, determining whether and how they should be applied in individual fact situations. These judicial interpretations do not form precedents which bind other subsequent courts.[13] Nonetheless, they offer a persuasive guide so that courts are generally careful to follow their own precedents and also give due consideration to the decisions of higher courts.

Occasionally, Japanese courts are asked to address situations which are only vaguely covered by statutory provisions. In such instances, the courts have been known to make law by interpreting a statutory provision extremely broadly. Subsequent codification of such judicial decisions underscores the role of the judiciary in the law-making process.

Perhaps the best known example of this interaction between the judiciary and the legislature is the codification of the abuse of rights doctrine. The concept of abuse of rights entered Japanese legal thought through French legal theory at the end of the 19th century. Essentially, the concept holds that ownership rights are not absolute, but rather must be exercised within the bounds of reason. Although there was no statement to this effect in the statutes at the time, in the 1910s, the Great Court of Cassation, then Japan's highest court, began using tort provisions to hold property owners liable for abuses of their ownership rights.[14] This doctrine continued to develop in the inter-war period until finally it was codified in 1947 as Civil Code Article 1(3).[15]

It can also happen, however, that judicial decisions which deviate or over-expand statutory provisions are never given this legislative approval. For example, Japan's Commercial Code does not contain a codification of the doctrine of lifting the corporate veil. Nonetheless, in the 1960s and 70s, Japanese courts showed themselves to be sympathetic to the doctrine in cases where the corporate form was used to evade legal liabilities. In spite of this fact, however, there has been no definitive judicial enunciation of the rule

13 Court Organization Law (Saibansho-ho), Law No 59, 1947, Article 4.

14 See Aoyama, 'Wagakuni ni okeru kenri ranyo riron no hatten' (Development of the theory of abuse of rights in Japan) in *Kenri no ranyo* (Abuse of rights), Vol 1 (1965) at 9ff. Translation in J Haley and D Henderson, (1988) 'Law and the Legal Process in Japan', Vol II at 198-215.

15 'Abuse of right is not permitted'.

and no codification of it by the legislature.

While in Japan judicial precedent does not occupy as important a role as it does in common law systems, clearly there is value in studying judicial attitudes, both for their interpretations of the Japanese codes and for any innovations they may introduce.[16]

Judicial genesis of the business judgment rule in Japan

On the business judgment rule in Japan, judicial precedent offers some interesting insights to the development of the law.

In one of the earliest cases discussing business judgment, a case decided by the Sendai District Court on 7 September 1977,[17] the board of directors of a partnership had planned to open a beauty college. The general members of the partnership were divided over the steps to take, so the plan was suspended. As a result, the organization lost over ¥726,000. The general members of the partnership sued the board of directors for neglect of their duty of care. In finding for the defendants, the court stated that the duty of care did not require that directors conceive of successful business plans but rather that their business plans were recognisable as likely to succeed.[18] In this early attempt at applying a business judgment rule, the rule appears to have had only one element: that the business judgment be such as would be considered viable by a third party.

Similarly, in the 2 March 1978 decision of the Tokyo District Court,[19] the plaintiff, Kitahara, lent money to Nihon Kikai Shoren Co at the request of the Ohashi brothers, two of the company's directors. The company was borrowing heavily and subsequently went bankrupt. Kitahara sued in an attempt to recover the debt. While Kitahara alleged that some of the proceeds of his loan were used by the brothers to finance a new company and maintained that this use of the money was gross negligence in violation of Article 266-3, his allegation was never proved. Rather, the Ohashis successfully defended the suit, showing that the money was used pursuant to an overall business plan calculated to save Nihon Kikai Shoren Co. Specifically, the court found that the borrowings were not used for personal gain but rather as part of a plan to make the business profitable. It went on to state that, considered from the perspective of a businessman of normal intelligence and background, the brothers' actions cannot be said to have been irrational.[20]

16 H Oda, *Japanese Law*, (1992) Butterworths, 53-4.

17 Hanrei Jiho (No 893) 88 (Sept 1978). Note, Japanese judicial decisions are reported by date and court, rather than by party names.

18 Ibid at 90.

19 Hanrei Jiho (No 909) 94 (Feb 1979).

20 Ibid at 99.

This case more clearly establishes that the business judgment rule requires rational decisionmaking by the directors relying on it. Interestingly, the case applied the rule as a limitation not on the Article 254(3) duty of care, but rather, on the Article 266-3 liability to third parties.[21] By applying what it calls a business judgment rule to an Article 266-3 case, the court is saying that a director who has behaved rationally has not acted in bad faith or with gross negligence.[22]

Perhaps the clearest statement on the business judgment rule to date has come in the 8 October 1980 decision of the Fukuoka High Court.[23] In that case, the board of directors of the plaintiff corporation made a decision to continue investment in a troubled subsidiary company. The overall business plan chosen was a gamble that the next fishing season would be profitable and would rectify the subsidiary company's difficulties. The alternative was for the parent company to cut losses by selling out. The subsidiary company failed even before the next season arrived and the corporation sued one of its directors alleging that the decision had breached the director's duty of care. The court stated that the director's duties to the corporation do not 'require the director to assume responsibility for the business performance of the corporation.'[24] It went on to find that 'a director should not be held to have violated his fiduciary duty if his actions were done in the best interests of the parent corporation and if the decision to make the loans was not outside the bounds of rational choices considered by businessmen.'[25]

Finally, in a more recent case,[26] the Tokyo High Court applied the business judgment rule as a limitation on both the director's liability to third parties under Limited Liability Company Law Article 30-3 (a parallel provision of Commercial Code Article 266-3) and the director's duty to supervise his fellow director. Sakai and his son were representative directors of A Company, which went bankrupt after expanding its business at a time when regulatory changes resulted in a contraction of demand. The plaintiff,

21 Article 266-3, which makes directors liable to third parties in the case of bad faith or gross negligence, is the most litigated provision in the Commercial Code. Because of the commercial registry system in Japan and the reliance of parties on the information contained therein, including the names of directors, Article 266-3 serves to protect third parties who dealt with a corporation on the basis of the reputations of its directors. Although its original purpose is not clearly known, Article 266-3 often provides a deep pocket for recovery when the corporation is unable to pay.

22 The Tokyo District Court went one step further in its 30 September 1980 decision applying the business judgment rule to find that, because the director's actions did not exceed the company's scope as prescribed in its articles of incorporation, he was not liable to a third party under Article 266-3. The criticism of the business judgment rule this case evoked will be discussed below.

23 Hanrei Taimuzu (No 433) 149 (1981).

24 Translation in M Tatsuta and R Kummert, *Cases and Materials on Japanese and US Business Corporation Law* Vol. II, (1990) Temporary Edition at 8-32.

25 Ibid.

26 Hanrei Taimuzu (No 723) 243 (1989). 28 February 1989 decision of Tokyo High Court. See translation in this volume.

a supplier of A Company, held several notes issued by the son on behalf of A Company and filed suit alleging that Sakai is liable on these notes because he failed to properly supervise the son's management of A Company. The court held that Sakai can only be liable for failure to supervise if in fact the son's management was conducted in bad faith or with gross negligence, the criteria for liability to third parties. However, since the son's decisions can be considered rational under the circumstances, then Sakai's supervision of his son is not faulty. There is no liability.

Scholarly interpretation of the business judgment rule

Japanese courts have referred to their rationale in these cases as a 'business judgment rule' (keiei handan kisoku). Indeed it is often discussed by commentators and in the cases themselves as if it was a well-settled rule. In particular, scholars treat the rule as a part of the interpretation of Article 254(3).

Scholarly opinion plays an important role in the development of legal theory in Japan. From the time that German-style civil law was introduced at the turn of the century, judges have looked to scholars to explain the law, particularly those aspects which are new or alien.[27] Their opinions, while rarely explicitly cited by courts, can be quite influential. As a consequence, scholars tend to lead the law, rather than follow it. This appears to be the case with the business judgment rule.

As mentioned earlier, Commercial Code Article 254(3) requires directors to perform with the care of a 'mandate'; ie, with the care of a good manager. This duty of care makes a corporation director liable to the corporation for any damage it sustains as a result of his negligence or inexperience in management.[28] It is logical to infer from this that directors are not liable for losses resulting from their corporate decisions if those decisions were properly approved by the board after informed debate.[29] It is on the basis of this inference that some scholars argue in favor of a business judgment rule for Japan.

According to Professor Tatsuta, three conditions must have been met for the business judgment rule to be applied:

(i) all necessary information must have been gathered and considered in making the decision;

(ii) there can be no conflict between the interests of the director and those of the company; and

27 Above n 16 at 63.

28 K Kusano 'Corporate Law of Japan' in H Oghigian, (ed) *The Law of Commerce in Japan* (1993) Prentice Hall, 19 at p 27.

29 Ibid at 27-8.

(iii) that the decision would not be viewed as strange by another person in the same circumstance operating with the same information (ie, the decision must be rational).[30]

While these three conditions are remarkably familiar to those conversant with the American business judgment rule, it is notable that none of the cases discussed above have required all three of these conditions. In his commentary analysing the 30 September 1980 decision of the Tokyo District Court[31] Professor Morimoto canvasses a number of scholarly opinions on the rule and concludes that its application in duty of care cases requires consideration of a single test: whether the director's performance of his job was exercised within the scope of choices which would be considered rational by another similarly situated businessperson.[32] Thus, it appears Professor Tatsuta is stating the law as he feels it should be. His statement of the business judgment rule is an attempt to lead the law. It is interesting to note that Kusano, writing in English for a western audience, describes the rule in the same way as Professor Tatsuta does.

There is little doubt that the Japanese judiciary is considering business judgment in duty of care cases. The question is more whether it can be said to be applying a business judgment rule and, if so, the exact nature of that rule. Indeed, Professor Suzuki has noted in his commentary on the Sakai case, that there is no consistency in the business judgment rule being applied by the judiciary.[33] Although he was referring to the content of the rule as it has been applied in cases considering the director's liability to the company, Japanese judicial application of the business judgment rule has also been inconsistent insofar as it has also been applied in cases considering the director's liability to third parties. It is in these cases that the use of the rule has become controversial.

Insofar as directors are liable to third parties for acts which are in bad faith or grossly negligent and a rational business decision can be said to be proof of good faith,[34] it is understandable that judges might be tempted to apply what they are calling the business judgment rule to determine that there has been no bad faith. However, as Professor Suzuki points out, this does not address the question of whether the director's actions were grossly negligent. On the other hand, Professor Kondo suggests that where a court can find that the director's decision was an exercise of business judgment that fact should, as a matter of policy, indicate that there has been no gross negligence.[35]

30 Tatsuta at 90.

31 Hanrei Jiho (No 1034) 178 (May 1982).

32 Ibid at 184-5.

33 Shoji Homu (No 1298) 29 at 31 (Sept 1992) (at 6 in Hiro and Adam's translation).

34 Note that gross negligence was the standard adopted by the Delaware Supreme Court 'for determining whether a business judgment reached by a board of directors was an informed one'. See *Smith v Van Gorkom*, above no 3 at 873.

35 M Kondo, 'Torishimariyaku no Sekinin to sono Kyusai' (Director's Duties and Relief Therefrom), Part III, 99 Hogaku Kyokai Zasshi 1283 (1982) at 1343.

The future of the business judgment rule in Japan

Judicial decisions applying the business judgment rule have not yet established the rule in a clear and concise fashion. Nor have they been clear as to the situations in which the rule should be applied. Similarly, we see that legal scholars are unable to agree on the precise nature of the rule or on the situations in which the rule should be applied.

There has not yet been a Supreme Court decision applying the business judgment rule in any situation. It is unlikely that there will be a codification of the rule until such a decision has been brought down. If there is to be codification of a judicial statement of the business judgment rule it is essential that the judicial statement clearly enunciate the elements of the rule. As yet, no such statement exists.

If application of the rule were limited only to duty of care cases, at a minimum scholars would probably agree on the standard enunciated by Morimoto. The difficulty for the dissenting scholars appears to derive from the willingness of the courts to use the business judgment rule in liability to third party cases. For example, while Kondo argues in favor of the business judgment rule in third party cases in order to prevent harshness against directors, Morimoto feels that the business judgment rule should not be applied to excuse directors from their liability to third parties. Existing decisions by the Supreme Court addressing director liability to third parties indicate that the Supreme Court is unlikely to apply the business judgment rule to mitigate a director's liability to a third party.[36] Accordingly, if the Supreme Court were to consider applying the business judgment rule it would only be in a case examining a director's duty of care to the company.

The judicial use of the business judgment rule in Japan reflects a consciousness of American legal theories.[37] It is possible to speculate that the imprecision surrounding application of the business judgment rule in Japan derives from its importation from American corporation law without the 'caution and sophistication' prescribed by Professor DeMott.[38] In this regard, however, there is hope for the development of the rule. In its current state it is not 'law' in Japan; it is merely a judicial interpretation of directors' statutory duties. The Supreme Court and the Diet, which would only act on the recommendation of the relevant ministry, can be relied on to use caution and sophistication should they ever consider incorporating the business judgment rule into Japanese law.

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36 A survey of those cases is beyond the scope of this article. See discussions in Dziubla R, 'Enforcing Corporate Responsibility: Japanese Corporate Directors' Liability to Third Parties for Failure to Supervise' (1986) 18 Law in Japan 55 and Tatsuta M, 'Risks of Being an Ostensible Director' (1986) 8 Journal of Comparative Business and Capital Market Law 445.

37 See above n 35.

38 Above n 1 at 144.