THE ROLE OF CASE LAW IN JAPAN:  
A COMPARATIVE STUDY OF JAPANESE AND CANADIAN COMPANY LAW

by

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ABSTRACT

The relationships between case law and statute law in Japan are quite different from that in Anglo-Canadian law. Contrary to the literal interpretation adopted by the Anglo-Canadian courts, the Japanese courts use extremely flexible interpretative techniques. There are relatively frequent changes in precedents. Therefore, case law plays an important role in the development of law in Japan.

This paper is intended to introduce the role of case law in Japan to foreigners who study or work with Japanese law. First, the characteristics of the Japanese case law are discussed. Stress is put on the private law area, where the creative function of case law is the most evident. The historical background and problems of the Japanese approach are also mentioned. Then this paper compares and contrasts Canadian and Japanese approaches on five selected topics of company law, in order to show the role of the Japanese case law in actual issues in comparison to the frequency of Canadian legislative reforms. By combining the general discussion of the Japanese case law and the discussions of specific issues, it is intended to enable foreign readers to have a better understanding of the reality of Japanese case law and to facilitate their further study.
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Canadian Company Legislation

**BCCA:** British Columbia *Company Act*, R.S.B.C. 1979, c. 59.

**CBCA:** *Canada Business Corporations Act*, S.C. 1974-75-76, c. 33

**Old OBCA:** Ontario *Business Corporations Act*, R.S.O. 1980, c. 54, repealed by **New OBCA**.


Japanese Courts

**G.C.J.** The Great Court of Judicature, the predecessor of the Supreme Court in the pre-war period.

**S.C.** The Supreme Court of Japan.

**H.C.** High Court.

**D.C.** District Court.

**Sm. C.** Summary Court.

Japanese Companies

**K.K.** *Kabushiki Kaisha* (stock company), often pronounced as "Kabushiki Gaisha".

For other types of companies, their Japanese names are cited without modification: *Yugen Gaisha* (limited liability company); *Gomei Gaisha* (partnership company); *Goshi Gaisha* (limited partnership company).
I. INTRODUCTION

There is an increasing interest in the study of Japanese law in Canada, reflecting the development of the connection between Canada and Japan. Among a number of differences between the legal systems of both countries, is the relationship between case law and statutes. The manner in which the Japanese courts treat statutory provisions is totally different from that in common law countries. The Japanese courts use extremely flexible interpretations of statutory provisions to adopt new legal concepts. Substantial portions of the law are formed by this process. The Japanese law students learn this point when they begin to study the law, and it is generally accepted by the Japanese jurists and lay practitioners as a reality.

Common lawyers seem to have had a great deal of difficulty in understanding this point. The judicial process of interpretation is quite different from the approach in which they have been trained. Common lawyers who discuss particular legal questions arising in Japanese law with Japanese lawyers seem to be often puzzled and frustrated, and most English language texts do not discuss it in detail. It is obviously dangerous for common lawyers to give opinions on questions of Japanese law without understanding this difference in judicial approach.
There are many English language translations of constitutional cases and a great many books have been written on that area. The courts have evolved special principles of interpretation in the last thirty years and constitutional interpretation is a discrete and specialized area. Again, there are many English language materials concerning particular areas of the Japanese law, such as administrative law and antimonopoly law. Except for constitutional law, many of these are subjects which the Japanese law students study as options after learning the compulsory basic law courses. Conversely, the English language materials which illustrate the function of case law in the basic laws, such as contract law, criminal law and corporations law, in Japan are quite rare. Therefore, there seems to be a gap between the Japanese lawyers and the common lawyers with respect to the knowledge of the function of case law in Japan.

This thesis is intended to assist common lawyers and other foreigners in understanding the role of case law in Japan in the basic areas of private law, using examples drawn from corporations law. In Chapter II the characteristics of Japanese case law are discussed. It is stressed that the discussion is mostly applicable to the private law areas, where the most creative interpretative techniques are used. Other areas of the law involve some other considerations. For
example, relatively strict interpretations are used in the criminal law in Japan, where the civil law doctrine of nullim crimen, nulla poena sine lege governs. Obviously it is impossible to describe all aspects of the Japanese case law in this limited space. The following discussion is deliberately brief, and is not intended to be exhaustive. I have omitted other relevant issues, such as the philosophical arguments concerning "interpretation of law", or detailed comparisons with the laws of Germany and France, which have a great deal of influence on the Japanese law.

In Chapter III, I will compare the Canadian approach and the Japanese approach with respect to five selected topics of company law. This is to demonstrate how the Japanese case law works in actual issues. I chose those topics for the following reasons: Firstly, they show a striking difference between the Canadian approach and the Japanese approach. In Canada the reform of common law principles on these issues has relied on new legislation, whereas in Japan the law reform in relation to the same issues was achieved by case law. They also show the problems of the Japanese approach. Secondly, various interpretative techniques are well demonstrated in the Japanese case law on those issues. Thirdly, these company law topics are familiar to many people who have studied company law. It will be possible for them to grasp the point directly,
without taking pains to understand the nature of the topics
themselves. Also, these topics are of some practical value for
those who are involved in business transactions with Japan. It
is not intended to compare the company laws of both countries
overall. Nor is it intended to make any general argument that
the Japanese courts work better or worse than the common law
courts, although conclusions will be drawn in specific cases.
The object is to explain the judicial process in Japan through
concrete examples, some of which have not been explored in any
deepth in English before.

With respect to these topics, it is also necessary to
mention the role of scholarly arguments or debates in Japan,
which have facilitated the subsequent development of case law.
The arguments on each point are extremely detailed and
complicated, and I have omitted the arguments themselves to
make the discussion of the law plain and brief. I will mention
the role of scholarly arguments in the general development of
the law in Chapter II.

In short, I hope this thesis will be understood as an
introduction to the reality of the Japanese law which will
facilitate further studies by foreigners. Any one of the
company law examples discussed in this thesis deserves to be a
topic of a separate thesis on the substantive law involved.
Here the focus is on the court's role in developing the substantive law, a role which has been neglected and could lead to business misunderstandings and potentially great economic losses in the context of transnational transactions.

II. CHARACTERISTICS OF CASE LAW IN JAPAN

A. Function of Case Law in Japan

1. An Overview

There is the following basic difference in the relations between case law and statutes between Canada and Japan. In Anglo-Canadian law, relatively great importance has been given to the common law as the primary source of law, as compared with statute law. The courts have adopted a strict literal approach in interpreting statutes, and a presumption that only a precise and explicit statutory enactment can modify a common-law concept has been very powerful. Therefore, in order to secure immediate certainty, statutes tend to be complex and lengthy.¹

In Japan, particularly in the private law area, the situation is just the opposite. Statutes are considered to be the primary source of law, but this does not mean that the
courts stick to the language of statutes. On the contrary, the courts use extremely flexible interpretative techniques. The Japanese courts have no equivalent to the detailed rules of statutory interpretation in common law countries, such as the plain meaning rule, the mischief rule, the golden rule, canons of interpretation, use of the form of statutes as guidelines, the restriction on the use of legislative history, or various presumptive rules. In the private law area, courts often depart from the literal meaning of statutory provisions. While statutes remain simple and abstract, substantial portions of the law are created by courts through flexible interpretative techniques. In addition, frequent changes in judicial precedents are a substitute for amendments to statutes. I will mention this in a little more detail below.

Firstly, the judicial interpretation of statutes in Japan is totally different from the strict literal approach of the common law courts. The Japanese courts draw conclusions which are different from the literal meaning of statutory provisions. This is seen in the private law area. The Japanese courts do not have self-imposed restrictions on the statutory interpretations comparable with those in common law countries. Words of statutory provisions are interpreted either broadly or narrowly. Their application is limited by the creation of exceptions by courts, or extended to different
situations by analogy. They are supplemented with many rules created by courts. Also gaps between statutory provisions are filled in by courts. Sometimes courts use "ippan joko" (literally, general clauses), i.e. broad doctrines with sweeping effect, to overturn the ordinary principles of law. Some of these general doctrines are now codified, but it does not mean that courts cannot resort to them if there are no express provisions. For example, the "abuse of right" doctrine, perhaps the most popular example of general clauses among Japanese jurists, had already been recognized by courts before it was codified in the art. 1(1) of the Civil Code. Concrete examples of these court interpretations are shown in Professor Tanaka's comprehensive textbook on Japanese law.\textsuperscript{2} They will also be shown in the company law cases discussed in Chapter III of this thesis. For Japanese lawyers and legal academics, they are by no means exceptional cases. There are a number of other cases adopting equally flexible interpretations.

In addition, there is no restriction on the use of materials in making statutory interpretations. However, the Japanese courts seldom admit the fact that they are influenced by other materials. For example, although there is no restriction on the use of legislative history in the interpretation of statutes, courts seldom refer to them in their decisions.\textsuperscript{3} It appears that courts do not like to
curtail their free hand to interpret statues by referring other materials.

This approach is aided by legal academics. They engage in great efforts to build up interpretative arguments concerning each legal issue. Their approach is extremely creative. Court interpretations of statutes which look already flexible for common lawyers are often viewed by Japanese academics as "too rigid". Normally there is a great body of scholarly arguments behind the case law on each legal issue. Courts are often guided by these scholarly arguments, although there are cases in which courts adamantly refuse to follow the well-established scholarly argument on a particular point. However, courts seldom identify the scholarly source for a principle they may be accepting.

There are many debates and writings by Japanese academics concerning legal interpretation in general. However, at the risk of oversimplification, I would say that these general arguments are highly philosophical, and consist of what legal interpretation should be, rather than what courts are actually doing. Further, as courts do not make general comments on statutory interpretations, it is difficult to find out to what extent courts are influenced by these general arguments. Therefore, I would refrain from mentioning these
complex arguments. Suffice to say that there is a prevailing tendency towards liberal interpretations which coincides with the flexible approach adopted by courts.4

Secondly, there are frequent changes in case law in Japan. So far, I have used the word "case law" rather loosely. There is a Japanese word "hanrei" which is translated as "judicial precedent". However, its implication is totally different from the common law equivalent.5 As a matter of law, Japan does not have a rule of stare decisis. A court decision in one case is not binding in a subsequent case, regardless of the level of the courts concerned. Even the Supreme Court may render a decision which contradicts its former decision, although the Courts Act (Law No. 59 of 1947) requires a more careful procedure in such cases; i.e. such a decision must be rendered by the Grand Bench of all fifteen Justices, not by any of its Petty Benches, each composed of five Justices.

As a matter of fact, however, the legal opinions in the Supreme Court decisions are normally respected and followed by courts, including the Supreme Court itself. Indeed, the Supreme court often says "it is the judicial precedent of this court [citation of decision] that ..." When the Supreme Court renders a decision on an issue on which inferior court
decisions and scholarly arguments are confusing, legal academics say that "now this issue was settled by the Supreme Court." Nevertheless, compared with the common law countries, changes in judicial precedents frequently do occur in Japan. Here, again, scholarly arguments play an important role. Legal academics severely criticize court decisions which they consider wrong, and strongly urge changes. This also occurs when an old precedent becomes obsolete. Although the courts are more conservative in changing precedents, academics have often been successful in having courts make changes.

Therefore, with flexible interpretative techniques and the possibility of changes in precedents, case law has played an important role in the development of the Japanese law. This will be shown in the concrete examples in Chapter III.

2. Is the Japanese Company Law Exceptional?

One may argue that the company law in Japan is exceptional and does not bear out my observations thus far. In the first place, the company legislation has been frequently amended. Since the end of the World War II, the following changes have been made.
1948 The abolition of partly-paid shares.

1950 Broad amendments under the influence of the U.S. concerning share capital, the organs of the company and the position of shareholders.

1951 Further amendment to the shareholders' derivative action.

1955 Minor amendments to the pre-emptive right of shareholders, etc.

1962 Amendments to the accounting system for companies.

1966 Various partial amendments including conversion between par value stock and no par value stock, and restrictions on transfer of shares.

1974 Various amendments including changes to the audit system, interim dividend, cumulative voting, and convertible debentures.

1981 Broad amendments concerning stock, organs, accounting, and the creation of debenture with pre-emptive right.

Again, it may be pointed out that there are legislative amendments which have overturned court decisions just as in Anglo-Canadian law. For example, in the 1950 amendment, it was provided that the articles of incorporation must contain a provision concerning shareholders' pre-emptive rights. However, the legislation did not make clear what kind of provision was adequate, and one inferior court decision held that the prevailing style of provision was invalid. It caused a panic in the business world, which led to the 1955 amendment to the Commercial Code (Law No. 48 of 1899). By the
amendment, the requirement for a pre-emptive rights clause in the articles of incorporation was deleted. By the amendment, pre-emptive right could be given to shareholders or outsiders by a decision of the board of directors. But, in addition, a special resolution of shareholders was required to give the right to outsiders.

It was not long before another panic occurred. There was a widespread practice to issue new shares by means of a wholesale subscription agreement with a securities dealer. It was in substance a public offering. However, one inferior court decision held the practice invalid, because the agreement was to give a pre-emptive right to an outsider without a special resolution. Several inferior courts followed this decision. Again, this led to a request for an urgent amendment of the Commercial Code. In the 1966 amendment it was provided that a special resolution was required only if new shares were issued to third parties at an especially favourable price, and the requirement for both a resolution of a board of directors and a special resolution of shareholders was deleted.

Another important case involved the manner of transfer of a name-share. Before the 1966 amendment, endorsement of a share certificate was required, and the prescribed form of endorsement was either (i) a signature or (ii) a stamp of the endorser's name plus a seal impression. As this requirement
was useless and nothing but a nuisance, an endorsement by seal impression only was widely accepted. The Supreme Court held this practice invalid as it did not meet with the statutory requirement. In the 1966 amendment the requirement for endorsement was abolished, and now name-shares can be transferred simply by delivery of share certificates.

These examples do not negate the general observation I have asserted above. Those decisions, which provoked demand for amendments, were severely criticized. However, the inadequate results actually stemmed from defective statutory provisions in the first place. In most cases the courts use flexible interpretations to try to rationalize the existing, defective provisions. In some cases, their conclusions did not accord with commercial practice and thus forced legislative action. The post-war amendments of the company law are mostly concerned with mechanical or structural matters, and are totally incomparable with the overall reform of the common law achieved in Canadian company legislation. Many important issues still are left to the case law in Japan.

B. Historical Background

The Japanese approach derives from the unique history of the development of Japanese law. As there are ample studies
on this subject, I will pass quickly through this topic, focusing on the impact of foreign law and relations between case law and scholarly arguments.

1. Pre-War Period

Subsequent to the abolition of the feudal system, Japan immediately commenced the unprecedented modernization of its whole political and legal system. It was a process of rapid Westernization to cope with the Western powers. Establishment of a modern legal system was one of the main tasks of the leaders of the government. It was also a prerequisite for abolition of the humiliating unequal treaties with the Western powers.

Under these pressing needs, the leaders of the government completed this task with remarkable speed, finishing the first phase in their period 1870-1900. In compiling basic codes, they studied the laws of many developed countries. Most influential among these were the codified laws of France and Germany. Common law was not a convenient tool for this quick transplantation. This process of transplantation thus determined the course of development of Japanese law as a civil law system.
The study of German law soon achieved overwhelming importance among Japanese jurists. If we take the Civil Code (Law No. 89 of 1896), as an example, although its provisions were not necessarily a carbon copy of the German equivalent, Japanese academics and courts applied German theory in interpreting them. Professor Kitagawa calls this phenomenon "theory reception", and gives examples of the gap between the origins of the Civil Code and how it has been construed in accordance with German civil law theory. One notable example is Civil Code art. 416 concerning the scope of damages for non-performance of an obligation. It is widely acknowledged that this provision is mainly derived from the common law rule in Hadley v. Baxendale, (1854) 9 Ex. 341. However, the provision was interpreted according to the German theories of "adequate causation" and "the concept of unitary damages".

Initially, legal academics paid relatively little attention to court decisions. This situation was changed when two civil law professors, Shigeto Hozumi and Izutaro Suehiro formed a case study group at the Faculty of Law of the Tokyo Imperial University in 1921. Hozumi had studied in England and Suehiro in the U.S. They strongly advocated creative function of court decisions through liberal interpretations of statutes. Their activities not only brought an increase in
case studies by academics, but also improved the manner of law reporting. Since then, the development of case law and the studies of academics have continuously stimulated each other.

2. Post-War Period

After the World War II, Japan undertook a major reform of its legal system under the influence of U.S. A number of laws and rules were introduced from the U.S. to Japan. The domination of German law came to an end. The study of common law became popular. The scope of comparative jurisprudence was significantly expanded.

However, the way of thinking inherited from the German law firmly remains among Japanese jurists. Common law principles and rules were interpreted by them according to the civil law tradition. The study of common law further encouraged liberal interpretations of statutes.¹⁴ The strict rules of statutory interpretation in English law have never had an opportunity to grow in Japan.

Today, scholarly arguments have been diversified and, in comparison with case law, have lost a great deal of the authority which they enjoyed before the war. As more and more new issues were brought to the courts, case law increased in
its importance and prestige. However, case law and scholarly arguments still continue to stimulate each other's development.

C. Problems of the Japanese Approach

Needless to say, the Japanese approach has its own problems. I have selected several representative topics for discussion here; namely, the delay in legislative reform, the Japanese predisposition towards ambiguity in the law, and the lack of any effort to create effective remedy provisions.

1. The Delay in Legislative Reform

The importance of case law in Japan is coupled with the notable delay in legislative reform. There are several reasons for this.

Japan does not have a federal system. The whole country, with one hundred and twenty million people, consists of one jurisdiction. While it is very difficult to obtain a nation-wide consensus among people with diversified interests and thoughts, there is no parallel to the way in which a legislative reform in one jurisdiction stimulates the same in another jurisdiction, as seen in Canadian company law reform. (However, this may occur in the legislation of municipal
governments in Japan.) Further, as mentioned in the following section, there is a tendency among the Japanese people to leave the law in an ambiguous state.

The interests of legal academics are mostly addressed to building up a system or theory of interpretation within the scope of existing statutes. Until recently, relatively little attention was paid to the creation of new statutory provisions to solve problems.

The situation has been aggravated by the fact that a change of the ruling party has not occurred for decades. The Liberal Democratic Party has continuously been in the government for over thirty years, and opposition parties do not appear to have the power to replace it. This political climate discourages bold reform of laws.

Therefore, the Japanese courts are expected not only to improve and rationalize existing statutes, but also to tackle new areas which lack legislative solution. Unlike common law judges, Japanese judges do not make general statements about the appropriate methods of statutory interpretation in their decisions. However, their ideas are discussed in books and journals from time to time. Dr. Matsuda, when he was a Supreme Court judge, made the following comment in a speech at a study session of judges:
"In making judgments, of course we should not have an idea of drowning ourselves in the trend of the times, which is akin to the so-called purchase of futures. However, we should not stick to the words in statutory provisions for no purpose: we should interpret and operate the law in accordance with social conditions. Especially, a lot is expected in case law in areas in which statutes are left to be outdated with almost no amendment, despite changes in social conditions after its enactment, or areas in which legislative reform is neglected although it is required due to the rapid increase of new problems. I think it is quite natural that in the U.S., the creative function of case law is often seen in those States where legislation tends to be delayed."\(^{15}\)

Again, Judge Nozaki of the Tokyo High Court, in a round table talk with law professors, offered this view of the process of interpretation:

"The style of provisions of Japanese statutes are very abstract. Very diversified interpretations are possible. Secondly, in Japan legislative solutions in response to changes in social conditions are very seldom adopted. When attempts are made to amend something, big disputes often occur. This is particularly true in the case of fundamental laws. By the way, when I talk with Americal lawyers, they ask 'Is Japan a common law country?' When I say 'No', I am asked 'Why?' One Chinese professor suggested that I should answer like this: 'Common law is a custom-made suit, whereas continental law is an off-the-rack suit. Therefore, we imported the off-the-rack suit. Common law cannot be imported to a place which lacks the soil for it.' I think it is a very neat explanation and often use it.

But I think what was imported in the Meiji era [1868-1912] was a really over-sized suit. Therefore, at the time of passage of the legislation there was a great gap between the
statutes and the facts, and it was inevitable to consider how to fill in the gap when interpreting the statutory provisions. Moreover, as the legislative solutions were delayed, the interpretation became more and more important and difficult...

There is a tendency that while there is the greatest adherence to the legislative intent at the time of enacting legislation, its interpretation descends - in other words, becomes flexible - as the law consciousness of people increases. But when there occurs a problem which cannot be solved by ordinary techniques of interpretation, I think practitioners [i.e. judges] suddenly become bold - I mean, abruptly make a jump. For instance, the problems such as the preliminary registration security device are solved by making judicial decisions as if it was a common law country. But as they are very timid until they reach that point, they try to resolve the problem with interpretative arguments based on the statutory provisions, and eagerly look for the basis to rely on.

A problem which arises is that we are going out of the era in which we can live on translations of foreign materials into Japanese by academics through the study of comparative jurisprudence. There is an increase of cases in which practice [i.e. courts] encounters new problems before scholarly opinions do. I think labour litigation, administrative litigation, pollution litigation, medical litigation and so on are particularly areas where this is evident. Then the question is what we should do where there is nothing? Even on that occasion we have to make up our minds. In this sense, I expect that from now on there will be a significant increase of cases in which practitioners [i.e. judges] must make a jump. ¹⁶

This kind of view is expressed by many other jurists in Japan.
However, the law reform by judges has its own limitations. Moreover, law reform by statutory interpretations is restricted by the given statutory framework. It would be wrong if we use the efforts of judges as an excuse for the neglect of legislative reform.

2. The Japanese Predisposition Towards Ambiguity of the Law

There is an outstanding tendency in Japanese legislation, case law and contract drafting: they are all rather short and abstract in form, and tend to lack certainty.

As noted by Judge Nozaki, Japanese statutory provisions are abstract and allow a variety of interpretations. Also, as shown in the topics of company law discussed below, there are occasions in which legislators deliberately leave the solution of controversial issues to case law.

Court decisions which interpret statutory provisions are also abstract in Japan. As to the style of court decisions, conciseness is preferred. Japanese judges do not cite scholarly arguments at all, no matter how they are in fact influenced by those arguments. Former decisions are not cited either, unless they are important Supreme Court decisions.
They express their way of thinking to a lesser extent than do common law judges.

Like legal academics, Japanese judges tend to deduce conclusions from general principles, and pay not so much attention to facts of cases as common law judges do in deciding legal issues. Rules laid down by them are rather broad, and not so specific. For example, as discussed in Chapter III, the Supreme Court set out two criteria of disregard of the corporate entity in Hoshihara v. K.K. Yamayoshi Shokai. Dr. Matsuda who was an advocate of the doctrine and joined this decision, later commented in his book that:

"...disregard of the corporate entity mentioned in this decision concerns cases in which a corporate entity 'is nothing but a shell' and cases in which a corporate entity 'is abused to circumvent the application of law', and I expect the concrete application of these principles [to be spelt out] in the accumulation of judicial precedents hereafter."  

It may be said that his view represents that of other Supreme Court judges. That is, the Supreme Court does not make the criteria more specific, and leaves their concrete application to subsequent decisions.

This approach may be inevitable because the doctrine of disregard of the corporate entity is itself broad in its
nature. However, this kind of approach is often seen in a wide variety of legal issues. Whenever the Supreme Court sets out some broad principles, commentators say "we should wait and see the development of the cases." Even legislators take this approach.

Therefore, one often faces difficulty in ascertaining the scope or true meaning of court decisions. Professor Haley, in his article concerning the Japanese case law on preliminary registration security device, expresses his dissatisfaction as common lawyer:

"These decisions also illustrate a disconcerting propensity by Japanese courts to leave unanswered many of the most crucial issues in a case. Too often the court speaks to the general principle and not the issue of detail. In a system where the litigated answer is swift and efficient, perhaps this would not be so telling a concern. But in Japan litigation is protracted and costly, thus such as those here that impose a duty by the secured creditor upon foreclosure to dispose of the collateral without offering any guidelines as to what standards shall apply to such disposition leave an uncertainty that is difficult to justify." 19

A similar phenomenon can be seen in the practice of contract drafting in Japan. Japanese contracts are normally simple and abstract. They lack detailed mechanisms for dispute settlement which are common in contracts in North America. Drafting techniques are underdeveloped. Little effort is made
in advance to prevent possible disputes by skillful drafting. An immediate answer is that Japanese businessmen consider a contract as a kind of harmonious relationship. They think highly of negotiation as means of dispute settlement. They are afraid that the other party may feel detailed contract terms offensive, particularly those that anticipate disputes between the parties.

However, there seems to be one fundamental characteristic behind all legislation, court decisions and contract drafting: a distaste for detailed rules and a tolerance (or even preference) for ambiguity. This reflects the peculiar role of law in the Japanese culture.  

3. **The Lack of Effort to Create Any Effective Remedy Provisions**

Professor Tanaka and Takeuchi severely criticize the failure of the Japanese legal system to provide private persons with adequate means of enforcement of law, and demonstrate this failure by comparing various topics in Japanese law and American law. They point out that characteristics of legal scholarship in Japan is one of the causes of this failure. Namely, the primary concern of legal scholarship is to expound on statutes and to comment on cases without paying full attention to the actual working of the law, and to build up a magnificent system of one's own theories.
The lack of remedies are also evidenced by comparing remedy provisions in Canadian Company legislation and their Japanese counterparts. In Canadian Company legislation, there are well-designed remedy provisions which contain various schemes to facilitate action by injured parties, such as expanding the range of possible plaintiffs (for example, the range of people who could challenge *ultra vires* acts), broad causes of action, wide remedial powers of the court, and other elaborate mechanisms for enforcement of law by private actions. Those provisions are based on the following fundamental idea:

"... we feel that the best means of enforcing a corporations statute is to make it largely self-enforcing, that is, by giving aggrieved individuals a reasonable opportunity to initiate private civil action to resolve their complaints; if this is done, we believe the need for administrative enforcement will become largely residual."23

The situation in Japanese company law is quite the opposite. The remedy provisions are narrowly designed. There are many statutory and factual obstacles which discourage enforcement of the law by private persons (e.g. in a shareholders derivative action, the court may order the plaintiff to post a bond). As noted in the Tanaka and Takeuchi article, leading scholars still stress the need to put further restrictions upon shareholders' derivative actions, on
the grounds that there is a "possibility" of abuse. Now, Japanese academics are changing their former approach. Yet I feel an enormous difference when looking at Canadian company legislation and the idea lying behind.

Where the statutory framework discourages the private enforcement of law, it is impossible to expect much development of case law in that area, no matter how academics try to build elaborate theories. We cannot count on case law for law reform without plaintiffs. The necessary thing is the conscious effort to provide for effective remedies by legislative reform.

FOOTNOTES (Chapter II)


2 Tanaka ed., The Japanese Legal System (1976), 61 et seq. I received many suggestions from this book.

3 Professor Tanaka notes that in all cases reported in Saiko Saibansho Hanrei Shu, the official reports of Supreme Court cases, for the years 1965 to 1972, the Supreme Court made no reference to legislative history except one in a dissenting opinion: ibid., 97.
One of such arguments available in English language is Kato, "Logic and Balancing of Interests in Legal Interpretation" in 2 Law in Japan: An Annual 80 (1968). Although his view is not necessarily the same as that of other academics, it reflects the general tendency towards liberal legal interpretation.


The following examples were taken from Tomiyama, "The Characteristics of Commercial Cases" 2 Law in Japan: An Annual 108, 118 (1968).


Civil Code art. 416 reads as follows:

"Article 416

(1) A demand of compensation for damages shall be for the compensation by the obligor of such damages as would ordinarily arise from the non-performance of an obligation.

(2) The obligee may recover the damages which have arisen through special circumstances too, if the parties had foreseen or could have foreseen such circumstances." (translation in 2 EHS Law Bulletin Series No. 2100)

14 For reference, I only mention two essays English translations of which are available: (1) Kato, "The Concerns of Japanese Tort Law Today - In Comparison with American Law", 1 Law in Japan: An Annual 79 (1967) asserts the necessity of learning from the tort law of the U.S. for creative interpretation of tort provisions in the Civil Code of Japan. (2) Shibuya, "Fiduciary Duty of Directors - Fairness in Regulation of Corporate Dealings with Directors", 5 ibid. 115 (1972), written before the 1981 amendment to art. 265 of the Commercial Code, sought to draw a reasonable scope of director's dealings with his company regulated under that provision by examining the solutions in Anglo-American law.

15 "Saikosai yori Mita Minji Saiban" (Civil Justice Seen from Supreme Court) in Matsuda, Watashi no Shosu Iken (My Dissenting Opinions) (1971) 435, 449 (translated by the author).


17 Marsh, "Is the Law Too Rigid?" in Devlin et al., What's Wrong with the Law? (1970) 26, 29-31, points out following problems in law-reform by judges:

(i) The reforming decision is quite fortuitous in its operation. The public may have to wait many years before an appropriate opportunity arises in the courts to right an injustice or clarify an obscurity.

(ii) Judge-made reforms, until finally approved at the highest level of the courts, are of uncertain stability.

(iii) The most minor changes in the law often turn out to have much wider implications than was at first realized. However, a judge can only carry out a patching job, restricted as he is by the circumstances of the case before him. He is seldom in a position to take account of all the implications of a new development of the law.

(iv) Since the law-reform by judges has a retrospective effect, it may be very unjust to one of the parties before the court.
18 Watashi no Shosu Iken, supra, n. 15, 314 (translated by the author).


22 Iacobucci et al., Canadian Business Corporations (1977) 187 et seq.

23 Ibid., 187 (footnotes omitted).

III. EXAMPLES - SOME TOPICS OF COMPANY LAW

Preliminary Comments

For the reasons mentioned in Chapter I, I have selected following topics of company law for comparison between the Canadian approach and the Japanese approach:

A. The Ultra Vires Doctrine
B. Pre-Incorporation Transactions
C. A Director's Transactions with His Company
D. The Director's Duty of Care, Diligence and Skill
E. Lifting the Corporate Veil

I have tried to describe the status of case law and statute law in both countries objectively and briefly. Therefore, I refrained from going into abstract discussions. For the discussion of Canadian company legislation, I selected the Federal, British Columbia, and old and new Ontario Acts (see the list of abbreviations). The comparison between the old and new Ontario Acts shows drastic legislative changes under the influence of the Federal Act. Such a situation is alien to the Japanese company legislation.

The discussion of the Japanese company law is primarily for the stock company, although some relevant cases
concerning other types of companies are also cited. I deliberately omitted introductory explanations of Japanese company law, because they are readily available in other English language materials, and their inclusion would make the discussion lengthy and complicated, due to the variety of topics. Therefore, I will directly go into the discussion of specific topics, assuming that the readers may obtain a basic knowledge of Japanese company law elsewhere.

FOOTNOTES (Preliminary Comments)

1 In completion of this chapter, I generally referred to the following materials:

Iacobucci et al., Canadian Business Corporations (1977);

Beck et al., Business Associations Casebook (1979);

Palmer et al., Canadian Company Law - Cases, Notes & Materials (1978);

Kitazawa ed., Hanrei to Gakusetsu (Case Law and Scholarly Arguments) Vol. 5, Shoho (Commercial Code) I (1977);


Other materials I referred to are cited in discussions of respective topics.

All translations of the Japanese court decisions quoted below were prepared by myself.
A. The Ultra Vires Doctrine

In Canada, as well as in England, the ultra vires doctrine in the common law was relaxed by the courts and circumvented by skillful drafting techniques, and finally abolished by legislation. In Japan, the doctrine was codified from the beginning, but it has been virtually abolished by court interpretations. In both countries a nineteenth century concern to limit the activities of the "unnatural legal persons" to ascertainable objectives has given way to an acceptance that they can operate in the economy to much the same extent as natural persons.

1. Canada

(1) Common Law

Although there are abundant studies on this subject, it will be worthwhile restating the history of the common law position briefly for comparison with the Japanese approach.

After some preliminary case law history, the ultra vires doctrine was established with respect to a company incorporated by a statute in Ashbury Railway Carriage & Iron
Co. v. Richie. The doctrine asserts that a company has only such powers as are authorized in the objects clauses of the memorandum of association. Any act which a company does not have power to do is ultra vires and void. Even the unanimous consent of all shareholders cannot ratify it.

The doctrine was developed to protect both the shareholders and creditors of a company. The doctrine would assure that the activities in which shareholders thought they were investing would be maintained and that the assets of a company would not be used for activities which creditors did not anticipate.

Shortly after the Ashbury case, the House of Lords in Attorney-General v. Great Eastern Railway Co. relaxed the rule of interpretation of the memorandum of association. It held that the doctrine should not be unreasonably applied, and that whatever may fairly be regarded as incidental to, or consequential on, the specified objects should not be held ultra vires, unless expressly prohibited.

While the court decisions accumulated as to the application of this rule, practitioners preferred to avoid the uncertain process of resorts to the courts for interpretative guidance. Therefore, it quickly became common practice to
include a lengthy list of ancillary objects in the memorandum of association. The courts confronted this practice with the *ejusdem generis* rule, i.e. that general words or clauses must be interpreted in the context of the main objects.  

Practitioners tried to avoid the rule by an "independence clause" to the effect that each of the objects specified shall be construed independently and shall in no sense be limited by reference to any other object clause. The House of Lords, although reluctantly, approved the validity of such clauses.

In *Bell Houses Ltd. v. City Wall Properties Ltd.*, the English Court of Appeal upheld the validity of a subjective clause in the following terms:

"to carry on any other trade or business whatsoever which can, in the opinion of the board of directors, be advantageously carried on by the company in connection with or as ancillary to any of the above businesses or the general business of the company" (emphasis added)

The court held that under this clause the *bona fide* opinion of the directors is sufficient to decide whether an activity of the company is *intra vires*. In *H. & H. Logging Co. Ltd. v. Random Services Corp. Ltd.*, the British Columbia Court of Appeal accepted the *Bell Houses* decision as expressing the law
of the Province. This decision was more far-reaching than the *Bell Houses* decision, because whereas in *Bell Houses* the court held that the act in question also came within the ambit of some other objective clauses, in *H. & H. Logging* the court could only rely on the subjective clause, whose wording was similar to that in the *Bell Houses* case. Those decisions symbolize the victory of skilled draftsmanship in avoiding the doctrine.

As a result, the effectiveness of the doctrine in achieving the purposes mentioned in the *Ashbury* case has been undermined by carefully drafted objects clauses. Yet the doctrine had become not only a nuisance to the company itself, but also a trap for a third party dealing with the company. It had a perverse effect on creditors.

Companies incorporated by letters patent, such as an Ontario company, gave rise to a different judicial interpretation. *Bonanza Creek Gold Mining Co. v. The King* is generally taken as having held that such a company had the capacity of a natural person and that the *ultra vires* doctrine was not applicable to it in the absence of statutory restrictions. However, the situation after that case was confusing. Since there is no Japanese equivalent to letters patent companies, further discussions of the Canadian experience in this respect is unnecessary.
(2) Statutory Reform

The basic scheme of the statutory reform of the doctrine in Canada is to confer on a company the power and capacity of a natural person (except for the old OBCA), to protect the validity of an act of a company which would be otherwise invalid under the doctrine, and to provide interested parties with a mechanism for restraining a company from doing an act in contravention of the memorandum or articles.

(a) Old OBCA

The old OBCA adopted a compromise solution. Although it did not abolish the doctrine completely, it eliminated the inconveniences of parties dealing with a company. Under the Act, the articles of incorporation must set forth the objects for which the corporation is to be incorporated. A lengthy list of powers are provided as incidental to the corporation's objects, but they can be withheld or limited by the articles.

The Act provides that no act of a corporation, otherwise lawful, is invalid by reason only that the corporation was without capacity or power to do such an act. However, such lack of capacity or power may be asserted:
(i) in a proceeding by a shareholder for a restraining order mentioned below;

(ii) in a proceeding by the corporation against a former or present director or officer; or

(iii) as a cause for the cancellation of the certificate of incorporation of the corporation.\(^{15}\)

Upon an application of a shareholder, a court may, when it thinks it to be just and equitable, restrain or prohibit a corporation from doing any act on the grounds that it lacks the capacity or power to carry out the purpose.\(^{16}\) Only a shareholder is entitled to this remedy. However, s. 252 of the Act, if applied literally, also allows a creditor to seek compliance relief.

(b) **BCCA, CBCA and New OBCA**

The BCCA and the CBCA went further and abolished the doctrine, and the new OBCA followed the CBCA approach. Those Acts provide that a company has the power and capacity of a natural person.\(^{17}\) However, the BCCA excludes certain prohibited types of business from this principle.\(^{18}\) It is unfortunate that the doctrine survives to this extent.
None of these Acts require objects clauses to be included in the memorandum or articles. A company cannot carry on any business or exercise its power in contravention of restrictions in its memorandum or articles. But no act of a company is invalid by reason only that the act contravenes its memorandum or articles, or the Act.

The BCCA specifically provides for a compliance remedy for a contravention of the restrictions included in the memorandum. The CBCA and the new OBCA do not directly deal with the remedy for this type of breach, but have more general compliance remedy provisions. The BCCA allows a member, a receiver, a receiver-manager, a liquidator, or a trustee in bankruptcy of a company to apply to a court for a restraining order, an order requiring compensation, or any other order the court considers necessary. The CBCA and the new OBCA have significantly expanded the scope of applicants for the remedy, i.e. a creditor and a "complainant". The latter is defined to include, inter alia, a registered holder or beneficial owner, former or present, of a security of a corporation or any of its affiliates, and any other person who, in the discretion of a court, is a proper person to make the application.

In the results a company incorporated under these Acts can engage in any activity unless specifically prevented from
so doing in its document of incorporation, a complete reversal of the old common law position. Companies now have wide transactional discretions.

2. Japan

(1) Codification of Doctrine

The Japanese Civil and Commercial Codes were enacted in the 1890's, after the establishment of the ultra vires doctrine in Anglo-American law. The doctrine was included in the new Japanese laws by a circuitous route.

The Civil Code has a chapter concerning "juristic persons," and art. 43 provides that a juristic person shall have rights only within the scope of objects set forth in the articles of incorporation. The Civil Code juristic persons are non-business entitles. Although business companies must specify their objects in the articles of incorporation, there is no equivalent of the Civil Code provision in the Commercial Code. But it has been established by court interpretations that the Civil Code provision is also applicable to business companies.

This article was included in the Civil Code when it was enacted in 1896. The Code was basically modelled on the
continental law of Germany and France, but the doctrine of ultra vires was taken from the Anglo-American law. As Professor Takeuchi contends:

"... we can find no clue that ... [the draftsmen of the Code] had compared and examined other legal systems, especially those of Germany and France, which do not recognize the doctrine; and there seems to have been no weighing of the actual advantages. The provision is said to have been enacted because suits had arisen in England and the U.S., but the truth is more that because this doctrine was recognized, many suits later arose, as is well known. The decisive reason why this doctrine was introduced into Japan seems to have been the chance circumstance that the chapter of Civil Code on juristic persons was drafted by Dr. Nobushige Hozumi, who had studied in England."

It was left to the courts to establish the applicability of their common law appendage to the civil law structure in concrete business situations.

(2) Reform by Court Interpretations

Unlike common law jurisdictions, in Japan no conscious effort was made to avoid the inconvenience of the ultra vires provision by inserting sophisticated, exhaustive, objects clauses. On the contrary, it has been a longstanding practice to draft objects clauses in a very simple manner. All draftsmen, both laymen and lawyers, use the following style:
(i) The main objects are stated briefly, for example, "to manufacture and sell furniture"; and

(ii) A short incidental objects clause routinely is added to the end, i.e. "to do any other objects incidental or related thereto".

Thus, it is not rare to see objects clauses which consist of only two or three lines. This is characteristic of the underdeveloped Japanese drafting technique in general.29

Therefore, the courts assumed all responsibility for rendering equitable results in each case. At first, the courts strictly applied the ultra vires provision by limiting the power of a company to the objects as expressly stated.30 As the inconvenience of this approach was evident, the courts quickly changed their standard. In 1912, the Great Court of Judicature held:31

"Articles of incorporation of a company include fundamental rules which set forth provisions concerning the company's business objects and management of the business. Since they ought to be concise and avoid redundancy as such, it is usual that articles simply list basic principles without going into details. Therefore, in determining the nature and scope of business objects of a company in accordance with clauses of its articles, the decision should not be made
simply by using the words concretely stipulated in the articles as the standard. Rather, it can be concluded that matters which can be logically inferred from the stipulated matters are included in the latter, even if they are not concretely referred to in the articles. Accordingly, a matter which is not stipulated in articles by corresponding words but which of itself can be considered to be contained in the matters of stipulated objects, should compose the object of the company. Also, a matter which is necessary for achievement of objects of a company should have the nature of the company's business within the scope of the objects, even if it is not stipulated in its articles."

The effect of this approach was to dissuade careful drafting and throw doubtful cases into the courts for interpretative solutions.

This decision was followed by a number of cases which broadly interpreted stipulated objects. In determining whether an act was necessary for the achievement of the stipulated objects, the courts initially treated it as a fact question depending on the circumstances of each case. As this approach inevitably involved uncertainty, the courts later began to consider the formal nature of the act as the standard for deciding whether the act was necessary to achieve the objects of the company. The Supreme Court confirmed this in *Kurozumi v. Shiomi et al.* as follows:

"... an act which is not included in the objects stipulated in the articles but is necessary for
the achievement of the objects should be considered to come within the objects of the association. The decision of whether an act is necessary for the achievement of the object should be done under the standard of whether it can be necessary objectively and abstractly by examining it in light of the entry of the articles itself, rather than the standard of whether it is in fact necessary for the achievement of the object stipulated in the articles of the company....This is because the question such as whether or not the act in question is in fact necessary for the association to achieve its objects, is a situation inside the association, and a third party can by no means know it precisely. If a third party cannot enter into a transaction with confidence unless he investigates such an inside situation, the security of trade cannot be maintained at all."

Under this broad standard, almost all cases after the World War II upheld the validity of allegedly ultra vires transactions of companies. In so holding, the courts broadly regarded those transactions as necessary for the achievement of corporate objects.

For instance, in Sekine et al. v. Oguchi K.K., a company whose objects were manufacture and sale of certain goods such as wooden products guaranteed the obligations of another company as lessee of land. It was held to be a necessary act in the absence of any counter evidence. The relations between the two companies, and the purpose of the guarantee, were not questioned. In Mizuno v. Daiichi Seimei Hoken Sogo Gaisha, an insurance company accepted monetary
deposits on a sporadic basis, not as part of its normal business. The court held that it was a necessary act from the objective and abstract point of view, and that whether the act was in fact necessary or not was irrelevant. In K.K. Takashimaya v. Tokyo Shoji K.K., a company whose objects were to mine, and to buy and sell metals, engaged in the purchase and sale of floor board, because its mining businesses were not in good shape. The court held that this was a necessary act, as the act was required to maintain the company. This seems to be somewhat inconsistent with the standard which is not concerned with actual necessity. In K.K. Toho Sogo Ginko v. Takechi et al, a company whose objects were to supply land and houses by mutual loan, made a monetary loan to utilize its funds. The loan was held intra vires from the objective, abstract viewpoint, and not invalid, despite the fact that it violated the restrictions on use of funds under the law governing its business.

Finally, in the most controversial of all modern company law cases known as "Yawata Seitetsu [or Yawata Steel] Political Donation Case", the Supreme Court dealt with the directors' liability for a political donation made by their company. One of the issues was whether such a donation was ultra vires. The court held as follows: a company can engage in social activities so long as they are expected or required
under the common notions of society. Since such activities have considerable value and effect concerning the smooth development of a company, they can be said to be indirectly necessary for the achievement of corporate objects. Therefore, to make a donation to a reasonable extent is within the power of the company. A political donation, as a means of assisting development of a political party, cannot be said to be *ultra vires*, to the extent that it is socially expected or required. The effect of these decisions is that there is almost no room for application of the *ultra vires* provision, in Japan today.

(3) **No Statutory Reform**

While the courts continuously rendered the *ultra vires* provision meaningless, in fact no attempt was made to repeal the provision, even in the extensive 1981 amendment to the Commercial Code and other company legislation. Similarly, the said requirement that objects be specified in articles of incorporation still remains unchanged. There has been no formal legislative reaction to the courts' role.

The Commercial Code, in art. 272, provides shareholders with an injunctive remedy with respect to a contravention of objects clauses. If there is a danger that a director will perform an act which falls outside the scope of
the company's objects, or any other act which contravenes the law or the articles of incorporation, and thereby will cause the company irreparable loss, a shareholder who has continuously held shares for the preceding six months may sue for an injunction to prevent the director's act.

This provision was enacted in 1950, but it has never been invoked to prevent an *ultra vires* act. No change has been made to enlarge the scope of possible plaintiffs to include, for example, creditors or shareholders of more recent date.

The foregoing history of the Japanese version of the *ultra vires* doctrine illustrates the characteristics of the Japanese legal process: abstract statutory provisions which do not necessarily conform to social needs, purposively elastic interpretations of statutes by the courts, underdeveloped drafting techniques, delay in statutory reform, and unwillingness to create effective remedy provisions. In contrast, in common law countries drafting techniques were developed to avoid the doctrine. Thereafter, Canadian company legislation completely reformed the doctrine. There are now provisions which are designed to provide shareholders and creditors with effective remedies. Also, the position of a third party who enters into a transaction with a company is specifically protected.
In Japan, the Civil Code provision which was supposed to perform the same function as that of the *ultra vires* doctrine is now left in an ambiguous state, unlike the present Canadian position.\(^{41}\)

**FOOTNOTES (A. The *Ultra Vires* Doctrine)**

2. (1875), L.R. 7 H.L. 653.
3. (1880), 5 App. Cas. 473.
4. *Re German Date Coffee Co.* (1882), 20 Ch. D. 169 (C.A.)
6. [1966] 2 Q.B. 656
9. In *Re Introductions Ltd.; Introductions Ltd. v. National Provincial Bank Ltd.*, [1970] Ch. 199, a bank made a loan to a company in connection with the company's sole business which was not expressly authorized by the memorandum but in fact carried out by it. The memorandum had a clause authorizing it to borrow money and an "independence clause". However, the court held that the loan was *ultra vires* the company notwithstanding those clauses, on the grounds that "borrowing is not an end in itself and must be for some purpose of the company ... you cannot convert a power into an object merely by saying so."
In *Re Jon Beauforte (London) Ltd.*, [1953] Ch. 131, a company purchased coke and used it for a business not authorized by the memorandum. The purchase was *prima facie* an *intra vires* transaction. But the seller was fixed with the knowledge of the unauthorized business described in the letterhead on which the company ordered the coke, and held disentitled to recovery.


12 S. 4(2)2.

13 S. 14(2)(3).

14 S. 15(1).

15 *Ibid*.

16 S. 15(2).

17 BCCA s. 21(1); CBCA s. 15(1); new OBCA s. 15.


19 The CBCA s. 16(1) and the new OBCA s. 17(1) expressly provide that it is not necessary to pass a by-law in order to confer any particular power on the corporation or its directors.

20 BCCA s. 22(1)(2); CBCA s. 16(2); new OBCA s. 17(2).

21 BCCA s. 22(3).

22 CBCA s. 16(3); new OBCA s. 17(3).

23 S. 25.

24 CBCA s. 240; new OBCA s. 252.

25 CBCA s. 231; new OBCA s. 244(b)(iii).

26 As to stock companies, see Commercial Code art. 166(1)(i).
27 E.g. Kyodochugyuba Gomei Gaiska v. Totsuka et al., G.C.J. December 21, 1901, 7 Minroku (11)76.

28 Takeuchi, "How Should We Abolish the Ultra Vires Doctrine in Corporate Law?", 2 Law in Japan: An Annual 140, 144 (1968) (footnotes omitted).

29 Ibid., 147.

30 E.g. Maezaki v. K.K. Toyotama Ginko, G.C.J. February 12, 1907, 13 Minroku 99 (guarantee of a promissory note by a bank was held ultra vires).

31 Dutch Gomei Gaisha Vanpelstein Endruperbossi (phonetic) v. K.K. Eijo Ginko, G.C.J. December 25, 1912, 18 Minroku 1078 (guarantee of a promissory notes by a bank was held to be included in the "loan" specified in the objects clauses).

32 E.g. Unknown v. Unknown, G.C.J. December 17, 1931, 3364 Shinbun 17.


34 S.C. February 15, 1952, 6 Minshu 77 (a company whose objects were "to maintain real estate and other property and to utilize and increase them" disposed of its sole important property to a third party. The transaction was held intra vires).


39 Mutual Loan Business Law (Law No. 42 of 1931), art 10.


41 Professor Takeuchi, in his article cited in n. 28, examines Anglo-American legislation and strongly recommends legislative reform on this issue in Japan. But there is no possibility that such a reform is realized in near future.
B. **Pre-Incorporation Transactions**

In the common law system, the courts applied the laws of contract and agency in dealing with pre-incorporation transactions. Inequitable results ultimately were solved by company legislation in Canada. In Japan, statutory provisions impose strict controls on such transactions. The courts have tried to mitigate their inconveniences by interpretations, but, again, the legislature has not responded to perceived deficiencies in the Code scheme.

1. **Canada**

   (1) **Common Law**

   The leading case on this matter is *Kelner v. Baxter*. The plaintiff entered into a written contract for sale of wine with the defendants, prospective directors of a company which was to be formed. The defendants signed the contract "on behalf of the proposed Gravesend Royal Alexandra Hotel Company Limited". The plaintiff delivered the goods to the defendants. Later the company was formed, and purported to ratify the contract. As the company collapsed before payment, the plaintiff sued the defendants. The court held that the company could not ratify the pre-incorporation contract to be
bound by it, and that the defendants who signed the contract were personally liable.

First, as to the question of the company's liability, the court used the laws of contract and agency; i.e. if a person has made a contract on behalf of a non-existing principal, a stranger cannot step in and ratify the contract. When a contract was made on behalf of a non-existing company, the company which later came into existence is a totally new creature, and therefore cannot ratify the contract.

Although this is faithful to the theory, the results may be contrary to the expectation of the parties and create inequitable results. But the courts stuck firmly to the no-ratification rule. Few alternative theories were available to mitigate the hardship of the rule. To use a device such as "adoption" of a contract is not effective, as "ratification" and "adoption" are synonymous. A so-called "provisional contract" is not useful either, as it is no contract at all.

The courts were reluctant to infer from the facts a new contract between a newly-formed company and the other party. In Re Northumberland Avenue Hotel Co. Ltd., the fact that a company acted upon a pre-incorporation contract was held insufficient to establish that a new contract was made, on the
grounds that "the company never intended to make any new contract, because they firmly believed that the [original contract] was in existence, and was a binding, valid contract."

The courts also refused the contention that a company which has received goods or services provided by the other party according to a pre-incorporation contract should be liable in equity. Therefore, unless the corporation decides to execute a new contract embodying the terms of the pre-incorporation agreement, the contracting party has little chance of enforcing the contract against the corporation, even though the corporation has had the benefit of the contracting party's performance.

As to the question of personal liability, the Kelner decision seemed to create the rule that a person who signed a contract for a non-existing company is personally liable on the contract. However, the limitation of the Kelner decision was clarified later by the English Court of Appeal in Newborne v. Sensolid (Great Britain) Ltd., and the High Court of Australia in Black v. Smallwood. In the former case, a contract for sale was signed by "Leopold Newborne (London) Ltd., per Leopold Newborne, director" as seller, and the defendant as purchaser. As the defendant refused to accept the delivery, the seller company sued the defendant. But it was
discovered that the company had not yet been incorporated when the contract was made. Mr. Newborne took steps so that he was substituted as plaintiff, but eventually his action was dismissed. It was held that the Kelner decision did not apply, as he did not purport to act as agent: rather, it was the company that purported to sell. The signature on the contract was the company's signature, and Mr. Newborne's signature merely confirmed it. As the company did not exist at the time of the contract, the contract was a complete nullity.

The Black case further clarified that the decisive factor should be the intent of the parties. The facts of this case were similar to the Newborne case: the signature of the purchaser on the contract for sale indicated a company name, and two individuals signed below with the title of "Directors". All of the parties believed that the company had been incorporated at the time of the contract. In dismissing the plaintiff's action against those signatories, the court refused to extract from the Kelner case the proposition that where a person contracts on behalf of a non-existing principal he is himself liable on the contract. In Kelner both parties knew that the proposed company did not exist. But it was not by reason of this fact alone that the defendants were held liable. The decision was that, in the circumstances, the written instrument disclosed the intention that they should be
bound by the contract. That intention could not be found in the Black case, where both parties thought that the company did exist. The contract was a nullity, as the supposed purchaser did not exist when it was made.

It follows that even if both parties knew that the principal company did not exist, a party who signed a contract for a non-existing company may escape liability due to a lack of intention that he should be bound. In Dairy Supplies Ltd. v. Fuchs, the defendants who were going to form a company purchased goods from the plaintiff. There was an agreement that the plaintiff was to look to the new company, and not them, for payment. The company did not pay. The plaintiff's claim against the defendants was barred by the agreement.

When there is no remedy in contract, the contracting party may sue the individual acting for a non-existing company only by breach of warranty of authority or deceit. But these actions require that the contracting party not know the non-existence of the company. Further, the measure of damages are inadequate; namely,

"... the warranty theory will not always be a satisfactory basis for liability, for the measure of damages in these cases is the value of the plaintiff's recourse against the principal. If the principal (in this case the company) is insolvent, or a mere shell, the plaintiff will
only be able to recover from the promoter the amount that would have been received as an insolvency dividend from the company, had it been liable.\textsuperscript{10}

This common law position caused major problems for people dealing with promoters in the honest belief that a company had been formed. Since the courts held fast to their position, legislation was necessary to remedy the situation.

(2) Statutory Reform

While the BCCA remains silent on this matter, the old and new OBCA and the CBCA have provisions to reform the common law principles.\textsuperscript{11} In short, a promoter who enters into a pre-incorporation contract is primarily liable. A company may adopt the contract to be bound by it, and the promoter will be relieved from the liability upon adoption. However, in order to avoid inequitable results, the court is given a power to apportion liability between the promoter and the company.

(a) Old OBCA

Under the old OBCA, a corporation may adopt a pre-incorporation contract entered into either in its name or on its behalf. Upon adoption the corporation will become entitled to the benefits and subject to the liabilities under
the contract, and the person who entered into the contract will cease to be entitled to such benefits or to be subject to such liabilities. If such adoption does not occur, that person remains entitled to the benefits and subject to the liabilities under the contract. But he is entitled to recover from the corporation the value of any benefit which it has received under the contract.

However, there may be cases in which the foregoing rules create inequitable results for the other party to the contract. For example, a company benefiting from the contract may refuse to adopt a contract and leave the other party only with a claim against an insolvent person. On the other hand, a person benefiting from the contract may cause his sham company to adopt the contract and escape liability. Therefore, the Act provides that whether or not the contract is adopted by the company, the other party may apply to a court to fix or apportion liability between the company and a person who entered into the contract in its name or on its behalf in a just and equitable manner.\textsuperscript{12}

(b) CBCA

The CBCA approach is essentially the same as that of the old OBCA. However, there are some significant differences.\textsuperscript{13}
(i) The CBCA provisions apply only to a written contract.

(ii) If a company is to adopt the contract, it must do so "within a reasonable time after it comes into existence."

(iii) The adoption of the contract may be done "by any action or conduct signifying its intention to be bound thereby."

(iv) There is no provision to the effect that when the person remains liable under the contract, he is entitled to recover from the company the value of benefit it has received.

(v) The Act confers on "a party to the contract" a right to apply to the court for an order fixing or apportioning liability between the company and the person acted in the name of or on behalf of the company. Presumably it includes such a person himself. Whether a company which has adopted the contract is included or not is unclear.
(c) **New OBCA**

The new OBCA adopted the CBCA provisions. The only change is that both oral and written contracts are expressly included.

2. **Japan**

(1) **Statutory Framework**

While the common law rule concerning pre-incorporation transactions comes from the strict application of principles of contract and agency, in Japan strict controls are imposed on pre-incorporation transactions by statutory provisions for different purposes. Namely, certain acts of promoters which are likely to injure the financial condition of a new company are subject to strict disclosure and reviewing requirements, and those acts which do not comply with the requirements are void. This is intended to protect the interest of shareholders of a new company.

For a complete study, it would be necessary to analyze all liabilities and restrictions imposed on promoters. Also, it would be necessary to analyze the fiduciary duty of promoters. However, in the following discussion I will focus
on (i) what controls are imposed on pre-incorporation transactions which a promoter enters into for a proposed company, and (ii) what solutions were made by the Japanese courts to curtail the inconveniences.

With respect to incorporation of a stock company, art. 168(1)(v) of the Commercial Code provides that "genbutsu shusshi" (literally, investment in kind, i.e. payment of shares in things other than money) is invalid unless specified in the articles of incorporation. An investment in kind is subject to reviewing procedures, including inspection by a court-appointed inspector. The purpose of those controls is to prevent issuance of shares for unfair consideration.

In order to prevent the circumvention of the above, art. 168(1)(vi) provides that an agreement in which the company is to acquire property after its incorporation is invalid unless it is specified in the articles of incorporation. This agreement, called "zaisan hikiuke" (literally, take-over of property), is subject to the same regulations as an investment in kind.

Further, art. 246 of the Code provides restrictions to prevent evasion of the rules concerning a take-over of property by a subsequent acquisition. If a company makes an agreement
within two years from the date of its formation for the acquisition of property which has been in existence since a time prior to its formation, and which is to be used for its business, and if the consideration for the acquisition amounts to one-twentieth or more of the paid-in capital of the company, it must be authorized by a majority of two-thirds of the votes cast at a shareholders' meeting. This kind of arrangement is called "jigo setsuritsu" (literally, ex post facto incorporation).

(2) Court Interpretation of Art. 168(1)(vi)

The "take-over of property" is more specifically defined by the Supreme Court as follows:

"The so-called take-over of property refers to an agreement in which a promoter acquires certain property for a company in the process of incorporation from a specific transferor of the property (who can be a promoter), subject to the formation of the company. It is an agreement which is entered into in the name of the company, and its content is that the rights and obligations under the agreement are to belong directly to the company, subject to the formation of the company."16

While it is clear that such an agreement is binding on the company so long as it meets with the Code's regulations, the Commercial Code says nothing about the effect of other
pre-incorporation transactions entered into by the promoters. The strict statutory controls caused the Supreme Court to take a narrow position:

"In light of the legislative intent of the Commercial Code art. 168(1)(vi), a promoter is not allowed to do anything other than the act necessary for incorporation of a company itself, even the act of preparation for opening of business: Only the take-over of property which is specified in the initial articles of incorporation and complies with other strict statutory requirements is permitted. According to the facts determined by the court below, the undertaking of liability in question was not specified in the initial articles of incorporation of the bankrupt company. As it is needless to say that this undertaking of liability cannot be construed as the act necessary for incorporation of the company itself, it must be said that the undertaking of liability in question is not effective on the bankrupt company, regardless of whether it is included in the take-over of property."

In other words, the "act necessary for incorporation of a company itself" ipso facto becomes binding on the company upon incorporation. The scope of this category is narrowly construed; for example, the act of receiving or depositing payments for shares. It should be noted that the Commercial Code in art. 168(1)(vii) provides that costs of incorporation cannot be attributed to the company unless specified in the initial articles of incorporation. Such costs are subject to the same regulations as in the case of investment in kind and take-over of property.
old cases of the Great Court of Judicature that to the extent such costs satisfy the statutory requirements, the company automatically succeeds to the liability for costs which a promoter owes to a third party upon incorporation. Whether the Supreme Court will follow this or not is unclear.

All other acts of a promoter are not binding on the company except for the take-over of property which complies with the statutory regulations. Those acts include, for example, purchase of goods, and leasing of offices, for business use after incorporation. Such acts are called "acts of preparation for opening of business."

The Supreme Court held that, in light of the strict statutory regulations, a take-over of property which does not comply with the statutory requirements cannot be rescued from a nullity by ratification of the company after incorporation. The nullity is not affected by the fairness of the price of the property. While a company can enter into a new agreement with the other party in accordance with the "ex post facto incorporation" requirements, a company cannot validate an invalid take-over of property by approving it by a special resolution. The nullity of the take-over of property can be asserted either by the newly-formed company or the other party.
Further, the Supreme Court has held that when a take-over of property is not binding on the company due to noncompliance with the statutory requirements, a promoter will not be personally bound by the agreement for the take-over of property, unless there are special circumstances, e.g. the existence of a special agreement between the parties, or circumstances in which statutory liability for an agent without authority is applicable.\(^\text{25}\)

(3) Solution of Inconveniences by Court Interpretations

As in the case of the common law, inconveniences created by the foregoing principles are evident. The Supreme Court attempted to minimize the perverse effects in the following cases by fixing personal liability on the incorporators.

In *Daichu Bussan K.K. v. Narita et al.*,\(^\text{26}\) promoters engaged in the sale and purchase of coal using the name of the proposed company, which had not been incorporated. The plaintiff sold coal to them. (Whether the plaintiff was misled by the company name or not is unclear from the report). The plaintiff sued the promoters for the price of the coal, alleging that they had engaged in the business as a partnership using the name of the company as a trade name, and as such entered into the contract. The action was allowed.
In *Daiei Yakyu K.K. v. Tsuji*, the defendant (T.) entered into an agreement in a company's name with the plaintiff. Although the company had not been incorporated, T. held himself out as the representative director of the company. The plaintiff, unaware of the non-existence of the company, performed the obligation under the contract, but T. did not pay consideration. The plaintiff sued T. under Civil Code art. 117 which provides statutory liability for an agent without authority. If a person enters into a contract as agent for another person and cannot prove his authority nor obtain a ratification from the principal, he is liable for the performance of the obligation or for compensation for damages, at the option of the other party, provided that the other party believed, without negligence, he had authority. T. contended that the language of the provision shows that it is applicable only when the principal actually exists. The Supreme Court held:

"As the contract in this case described by the court below cannot be said to be an act necessary for incorporation of the company, there is no reason why its effect is *ipso facto* attributed to the company after its incorporation. After all, the contract should be said to be analogous to an act done by T. as agent without authority. It is true that Civil Code art. 117 is basically a provision for the case in which one entered into a contract as agent for another existing person, and that T. who entered into the contract as representative of a not-yet-formed company in this case does not come within the category of an agent without authority in its original sense."
However, since the provision is based on the purpose of protecting the other party who entered into a contract with a person believing that he was an agent, with respect to this contract which has relations analogous to the foregoing it is reasonable to consider that T. is liable under the contract by application of the said provision by analogy."

There are some other inferior court cases using the same approach. This provides a bona fide contracting party with an effective remedy, as the courts do not have a theory comparable to that of the common law to reduce the amount of damages in case of the insolvency of the principal.

In Otsu v. Daiwa Kotsu K.K., the Supreme Court opened up a way to sue the company for unjust enrichment. The plaintiff was one of a group promoters who unanimously decided that a proposed company would acquire taxi cabs from the plaintiff. He executed an agreement to this effect as the transferor on the one hand, and as representative of the proposed company on the other hand. After incorporation, he delivered the cabs to the company believing that the agreement was binding on the company. The agreement was in fact null, because the Code requirements for take-over of the property were not complied with. Nevertheless, the company used and disposed of the cabs. The Supreme Court affirmed the decision of the lower court that even if the company's act amounted to ratification, the invalid take-over of property could not be
validated by ratification. The Supreme Court also held that the other promoters were not liable because there was no agreement to hold them liable, nor was there a situation in which the statutory liability of the agent without authority would be applicable. However, the Court held that there was room for a claim for unjust enrichment, and ordered the retrial of the case by the lower court. (The outcome is not reported.)

There are inferior court decisions which regarded the company as the successor to a lease agreement or a membership agreement of a golf club, when the company and the other parties continuously purported to act on the agreement. But the authority of these cases will be doubtful if the no-ratification rule is strictly applied in future.

Unfortunately, as in the case of the ultra vires doctrine, no legislative reform has been made to the statutory framework. The foregoing shows how the Japanese courts try to develop rules and exceptions based on a given statutory framework which is not necessarily adequate by creatively applying the available provisions. Thus in the pre-incorporation transactions area the company, once formed, can be made liable in limited circumstances employing art. 168(1)(vi) and the doctrine of unjust enrichment in the Civil
Code, and the promoters can be made personally liable by the statutory liability for an agent without authority or on the grounds that they personally engaged in the business. Although this is not a complete solution, the Japanese courts have reduced the inconveniences arising from the existing statutory provisions. This contrasts with the inflexibility of the common law rules which ultimately necessitated legislative reform.

FOOTNOTES (B. Pre-Incorporation Transactions)

1 (1866), L.R. 2 C.P. 174.


6 Iacobucci et al., Canadian Business Corporations (1977), 51.
11 Old OBCA s. 19; CBCA s. 14; new OBCA s. 21
12 In Bank of Nova Scotia v. Williams et al (1976), 12 O.R. (2d) 709 (H.C.), the court refused to exercise this power where the other party knowingly advanced money to the company in accordance with the contract and was not led to believe that the contractor was assuming any personal liability.
13 For more detailed discussion, see Iacobucci, op. cit., n. 6, 55-58.
15 Ibid.
19 Supra, n. 14
21 Otsu v. Daiwa Kotsu K.K., supra, n. 16.

24 Ibid.

25 Otsu v. Daiwa Kotsu K.K., supra, n. 16.

26 S.C. December 9, 1960, 14 Minshu 2994.

27 S.C. October 24, 1958, 1 Minshu 3228.

28 Supra, n. 16.

29 Civil Code, art. 703.


C. A Director's Transactions with His Company

In both Canada and Japan, there are controls on a director's transactions with his company in order to prevent abuse of his power. However, the process of law-reform is quite different.

In Canada the common law position on this matter has been greatly altered by detailed statutory provisions. In Japan simple statutory provisions have been rationalized by court interpretations. Only modest changes were made by legislatures, and important issues are still left to the case law.

1. Canada

(1) Common Law

The common law developed a strict rule by analogy to the fiduciary position of the trustee. A company can, at its option, avoid a contract in which one of its directors has a personal interest, and no question is allowed as to the fairness or unfairness of the contract. The interested director is liable to account to the company for the profit arising from the transaction. The scope of the interest has
been broadly drawn. It includes, for example, an interest as shareholder, director or trustee of the other party to the contract,\(^3\) or an interest in the land which a director purchases and submits to the company through the seller as security for a loan so as to pay off the purchase price.\(^4\)

However, this strict rule can be avoided by exculpatory clauses in the company's articles.\(^5\) Moreover, the contract can be ratified by the majority vote of the shareholders.\(^6\) When the interested director is also a shareholder, he is not precluded from the voting, even if the majority vote is only achieved by including his vote.\(^7\) The common law rule is firmly grounded in the concept of the shareholders as masters of the company.

(2) **Statutory Reform**

The BCCA, the old and new OBCA and the CBCA have detailed provisions to solve problems in the common law position. They impose disclosure requirement on an interested director, prohibit him from voting on the contract, prevent the shareholders' ratification of an unfair contract, and make it possible to relieve the director from the liability to account and to protect the validity of the contract. While there are a number of small differences among those statutes, new OBCA provisions are quite similar to the CBCA provisions.
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(a) **Scope of Interest**

There are minor differences among these Acts concerning the scope of interest. The provisions of the old OBCA apply only to directors. Those of the BCCA, the new OBCA and the CBCA apply to both directors and officers. Under the BCCA, the disclosure requirement is applicable only to a proposed contract, but under the old and new OBCA and the CBCA it is applicable to a contract, either current or proposed. The CBCA merely refers to "contract", whereas the BCCA and the old and new OBCA use the term "contract and transaction". The old and new OBCA and the CBCA require that both the interest and contract be material. The BCCA has no such requirement. For convenience, the following discussion will simply use the words "director", "contract" and "interest" for all of the statutes, despite these differences.

The BCCA and the old OBCA expressly include both direct and indirect interests. Instead, the CBCA and the new OBCA provides for the cases where (i) a director is a party to a contract with the company or (ii) he is a director or officer of, or has an interest in, a person who is party to a contract with the company, and both attempt to clarify the scope of an indirect interest by virtue of a broad definition of a "person".

9
The old OBCA includes a director's interest in a contract involving the purchase or sale of assets by or to the subsidiary of the company. The other statutes have no such provision.

The statutes have different exemption clauses. The CBCA and the new OBCA specify the following contracts: (i) an arrangement by way of security for money lent to or obligations undertaken by a director for the benefit of the company or an affiliate; (ii) a contract for a director's remuneration as a director, officer, employee or agent of the company or an affiliate; (iii) a director's indemnity or insurance contract; or (iv) a contract with an affiliate. The BCCA has similar exemptions. However, the effect of the exemptions is different. Under the BCCA, a director will not be deemed to have an interest in those contracts, whereas the CBCA and the new OBCA merely exclude those contracts from the prohibition on an interested director's voting.

The old OBCA exempts from the disclosure requirement only a contract for the director's remuneration as director, officer or employee of the company.
(b) Disclosure Requirement

The Canadian statutes have codified the case law that not only the existence but also the nature and extent of the interest must be disclosed. Further, the old OBCA has a specific disclosure requirement for a contract involving the purchase or sale of assets in which a director has an interest. If the property was acquired by the seller within five years before the date of the contract, the director must disclose the cost of the property to the seller and the cost to the purchaser, and thereby disclose the amount of gain from the transaction. But this provision was repealed in the new OBCA.

The CBCA and the new OBCA specifically require that the disclosure be made in writing to the company or that there be a request for an entry of the disclosure in the minutes of a meeting of the directors.

All of those statutes have detailed provisions as to the deadline of disclosure. The CBCA and the new OBCA provide separate deadlines for an officer who is not a director. The CBCA and the new OBCA impose a disclosure requirement on an interested person who later becomes a director. Further, the CBCA and the old and new OBCA have a provision concerning the disclosure of the contract which, in
the ordinary course of the company's business, does not come before directors or shareholders for approval.

All of those statutes provide that it is sufficient for an interested director to give a general notice (e.g. that he is a director of or has an interest in a party to the contract with his company), although there are minor differences.¹⁴

(c) Prohibition on Voting¹⁵

As to the resolution of directors on a contract in which a director has an interest, the BCCA and the Old OBCA provide that he must refrain from voting and must not be counted in the quorum. However, under the BCCA the exclusion from the quorum may be altered by the articles of the company. Under the CBCA and the New OBCA, an interested director is excluded from the vote, but not from the quorum.¹⁶

None of those statutes prohibits an interested director from voting on the contract as a shareholder at the shareholders' meeting, but they have safeguards as discussed below.
(d) Directors's Liability and the Validity of the Contract

BCCA:

An interested director must account to the company for the profit arising from the contract, unless he takes one of the following steps:

(i) He complies with the disclosure requirement, abstains from voting on the contract, and the contract is approved by the directors, or

(ii) The shareholders approve the contract by special resolution after full disclosure, provided that the contract was reasonable and fair at the time it was entered into.¹⁷

The failure to comply with those requirements does not automatically make the contract invalid, but the court may, upon the application of the company or any interested person, enjoin the company from entering into the proposed contract, or set aside the contract, or make any other order it considers appropriate.¹⁸
Old OBCA:

An interested director will not be liable to account for the profit if he acted honestly and in good faith at the time the contract was entered into, and the contract will not be voidable if it was in the best interest of the company at the time it was entered into, where

(i) he complies with the disclosure requirement and refrains from voting on the contract, or

(ii) the interest is disclosed in a notice of meeting or an information circular to the shareholders, and the contract is confirmed by two-thirds of the votes at the subsequent shareholders' meeting.\(^19\)

However, unlike the other three statutes, the old OBCA does not provide the requirement for an application for a court order to set aside the contract in the case of noncompliance with the above requirements.

CBCA:

If (i) a director complies with the disclosure requirement, (ii) the directors or shareholders approve the
contract, and (iii) the contract was fair and reasonable at the time it was approved, the contract is neither void or voidable by reason only that the director was interested in the contract or present at or was counted in determining the presence of a quorum at a meeting of the directors or committee of directors that authorized the contract.20

The CBCA does not have an express provision for the interested director's liability to account for the profit. The original bill for the CBCA provided that the director will be relieved from liability if the foregoing conditions (i) (ii) (iii) are met. But this provision was deleted in the revised bill for the reason that it had become redundant by virtue of what is now s. 117 of the CBCA (i.e. the general provision for the director's duties, including the duty to comply with the Act).21

If a director fails to comply with the disclosure requirement, a court may, upon the application of the company or a shareholder, set aside the contract on such terms as it thinks fit.22 Unlike the BCCA and the old and new OBCA, the CBCA does not have a curative provision which uses the shareholders' approval to remedy noncompliance with the disclosure requirement.
New OBCA

A director is not liable to account and the contract is not void or voidable by reason only of his relationship with the contract or by reason only that he was present at or was counted in determining the presence of a quorum at the meeting of directors that authorized the contract, if (i) he complies with the disclosure requirement and (ii) the contract was reasonable and fair to the company at the time it was approved.23

The new OBCA has a provision for the approval of the contract by a special resolution of the shareholders' meeting.24 Its conditions are similar to the equivalent provision of the old OBCA. An important difference is that the strict term "the contract was in the best interest of the corporation at the time it was entered into" was replaced by the term "the contract was reasonable and fair at the time it was approved".

If an interested director fails to comply with the statutory requirement, the company, a shareholder or in the case of an offering company, the Ontario Securities Commission, may apply to the court for an order setting aside the contract and directing the director to account, and the court may so order or make such other order it thinks fit.25
2. **Japan**

The basic statutory scheme on this matter in Japan is that the transaction which involves a conflict of interest between a director and his company must be approved by the board of directors, and that the director and other directors who approved the transaction are jointly and severally liable to the company for the damages sustained by the company due to the transaction.  

(1) **Scope of the Transaction**

Art. 265(1) of the Commercial Code provides two types of transactions which require an approval of the board of directors. The first is where a director enters into a contract with his company on his behalf or on behalf of a third person ("direct transaction"). The second is a contract between the company and a party other than a director which involves a conflict of interest between the company and a director ("indirect transaction").

A typical example of the indirect transaction is the case in which a representative director makes an agreement with his personal creditor on behalf of his company and thereby has his obligation undertaken or guaranteed by his company. Before
the 1981 amendment to the Commercial Code, the language of art. 265 covered only direct transactions. The Supreme Court originally denied the extension of art. 265 to indirect transactions, but later affirmed it by using a purposive interpretation as follows:

"The legislative intent of Commercial Code art. 265 is nothing but to prevent an act which is designed to benefit a director himself and is prejudicial to his stock company from being done arbitrarily, in the case in which a conflict of interest exists between the director and the company. Therefore, it should be held that the transaction referred to in this provision includes, as a transaction on behalf of the director himself, not only an act to be done directly between a director and the company with a conflict of interest, but also an act beneficial to the director himself and prejudicial to the company, such as an arrangement in which a director as a representative of his company agrees with his personal creditor to undertake his personal debt."

The 1981 amendment codified this conclusion.

According to the case law, when a representative director enters into a transaction which produces a conflict of interest between his company and another company of which he is also a representative director, the transaction comes under art. 265. On the other hand, the prevailing view is that the mere fact that two companies have a common director is not sufficient for applying art. 265 to the transaction between
them. In addition, there is a Supreme Court decision that a director's interest in another company as a shareholder is not sufficient.30

Although there are many arguments, the courts have continuously held that the issuance or endorsement of a promissory note by a company to its director comes under art. 265.31

On the other hand, the courts have denied the application of art. 265 to certain transactions between a company and its director which was not harmful to the company. They include, for example, the performance of an already fixed liability,32 a director's acquisition of the company's assets through auction proceedings,33 a director's donation to the company,34 and a monetary loan by a director to the company without interest and security.35 In so holding, the courts considered the formal nature of the transactions to be a decisive factor. However, there are a few cases where the courts held that the transactions were not harmful to the company by examining the substantial factors behind the formal character of the transactions.36
(2) Disclosure Requirement

The 1981 amendment added an ex post facto disclosure requirement. A director who effected an art. 265 transaction must report important facts about the transaction to the board of directors without delay. The failure to do this is punishable by a non-criminal fine. Its purpose is to let the board of directors know the outcome of the transaction so as to enable them to decide to hold an interested director liable for damages, if any, sustained by the company, and to ascertain that the actual transaction did not exceed the scope of approval.

Conversely, there is neither an express Code provision nor any development of case law on the prior disclosure requirement. While the existence of board approval often becomes the central issue of art. 265 cases, the extent of prior disclosure is not disputed.

(3) Approval of the Board of Directors

There is a provision that a director who has a "special interest" in a resolution of the board of directors is excluded from the vote and must not be counted in the quorum with respect to the resolution. A director involved in an
art. 265 transaction is considered to have a special interest and thus must not vote to approve the transaction. However, there is an inferior court decision that where all directors including an interested director has voted to approve the transaction, the approval is valid inasmuch as the other directors constituted the requisite majority.

It has been established by the courts that an *ex post facto* approval is valid. Whenever the approval is given, it must be made by the board of directors, and the approval made by the shareholders' meeting is invalid. However, the Supreme Court held that where all the shareholders of a company approved the transaction, board approval is no longer required.

(4) **Validity of Transaction**

The statutory provisions remain silent as to the validity of an art. 265 transaction without board approval. There is a significant development of the case law on this matter. Initially such a transaction was held to be voidable at the option of the company. Then it was held to be null and void. However, the courts have since held that it becomes valid by an *ex post facto* approval.
When the Supreme Court extended the scope of art. 265 to the indirect transaction, it created an exception for the sake of security of transactions; namely, the company cannot assert the nullity of an indirect transaction against the other party unless it proves that the other party knew of the lack of board approval. Then it extended the rule to the holder of a promissory note issued or endorsed by the company to its director.

In the course of drafting the 1981 amendment, it was proposed to put in a provision that the board of directors can avoid an art. 265 transaction which lacks its approval, provided that the avoidance is not effective against a bona fide third party. However, due to strong opposition, a provision along these lines in the draft amendment proposal was deleted and the matter was deliberately left to the case law.

(5) **Director's Liability**

The relevant provisions of the Commercial Code provide as follows:

(a) A director who effects an art. 265 transaction is liable to the company for the damages sustained by the company.
(b) A director who effects a monetary loan from the company to another director is liable to the company for the unpaid amount.

(c) A director who violates the law or the company's articles of incorporation is liable to the company for the damages sustained by the company.

(d) The directors who effect such acts or who vote for the resolution to authorize such acts are jointly and severally liable.  

The Code further provides that the liability of (a) can be relieved by a majority of not less than two-thirds of all issued shares of the company, whereas the liabilities of (b) and (c) can be relieved only by the consent of all shareholders of the company.

There is a confusion among scholarly opinions on those provisions. According to the majority opinion, while the liability of (c) requires the intention or negligence of the director,  

(a) and (b) are non-negligent liabilities; a transaction with board approval comes under (a) and that without board approval comes under (c); but a loan to a director, whether approved by the board or not, comes under
(b). Therefore, a director is liable even if he has obtained approval pursuant to art. 265. Ironically, despite the strict nature of the liability, there is virtually no case about the liability arising from an art. 265 transaction.

The 1981 amendment did not alter the above statutory scheme concerning directors' liability for art. 265 transactions. It was planned to repeal the above (a) (liability for art 265 transaction) so as to treat the art. 265 cases under (c) (liability for violation of law or articles of incorporation). However, the plan was abandoned due to the opposition that the abolition of non-negligent liability is inconsistent not only with (b) (liability for monetary loan to another director) which is considered to be a non-negligent liability, but also with the policy of strengthening the directors' responsibility.\(^5^5\)

When a majority of not less than two-thirds of the shares may relieve the director's liability, the position of minority shareholders may be impaired by the abuse of voting power of the director who is also a shareholder. Before the 1981 amendment, a shareholder having a special interest in the resolution was excluded from voting.\(^5^6\) The 1981 amendment removed this restriction and added a new safeguard. If a grossly unfair resolution is made by virtue of the director's
vote, the court may set aside the resolution in the special litigation proceedings.57

In short, in Canada exhaustive statutory provisions have entirely reformed the common law position. Those provisions are carefully designed to avoid ambiguity. Whereas in Japan statutory provisions leave a lot of uncleanness, changes in the case law concerning the scope of interest and the validity of transactions functioned as law reform. The 1981 amendment only made modest changes. Important issues such as the validity of transactions and application of liability provisions are still left to the case law. This illustrates the relative importance of the case law in law reform in Japan, and the lack of effort to remove ambiguity by exhaustive legislative reform.

FOOTNOTES (C. A Directors' Transactions with His Company)


2 Imperial Mercantile Credit Assoc. v. Coleman (1873), L.R. 6 H.L. 189.


5 Imperial Mercantile Credit Assoc. v. Coleman, supra, n. 2.


7 Ibid.

8 BCCA ss. 144(1)(4) 159; old OBCA s. 132(1)(2); new OBCA s. 132(1)(5); CBCA s. 115(1)(5).

9 CBCA s. 2(1); new OBCA s. 1(1).

10 BCCA s. 144(4); old OBCA s. 132(1); new OBCA s. 132(5); CBCA s. 115(5).

11 BCCA s. 144(1)-(3); old OBCA s. 132(1)(3)(6); new OBCA s. 132(1)-(4)(6); CBCA s. 115(1)-(4)(6).


13 BCCA s. 144(2); old OBCA s. 132(3); new OBCA s. 132(2)-(4); CBCA s. 115(2)-(4).

14 BCCA s. 144(3); old OBCA s. 132(6); new OBCA s. 132(6); CBCA s. 115(6).

15 BCCA s. 145(1)(2); old OBCA s. 132(1); new OBCA s. 132(5); CBCA s. 115(5).

16 The CBCA s. 115(7) and the new OBCA s. 132(7) provide, inter alia, that a contract will not be void or voidable simply because an interested director is counted in determining the presence of a quorum. Therefore, he can be counted in the quorum.

17 S. 145(1). Under the BCCA, a special resolution requires a majority of not less than three-fourths of the votes cast (s. 1(1)).

18 S. 146.

19 S. 132(4)(5).

20 S. 115(7).

21 Department of Consumer and Corporate Affairs, Detailed Background Paper for an Act to Amend the Canada Business Corporations Bill (1974), 27.
22 S. 115(8).

23 S. 132(7).

24 S. 132(8). Under the new OBCA, a special resolution requires a majority of not less than two-thirds of the votes cast (s. 1(1)).

25 S. 132(9).

26 Relevant provisions of the Commercial Code are as follows (translation in 2 EHS Law Bulletin Series No. 2200, slightly modified by the author):

"Article 265.

(1) When a director intends to acquire the company's products or other properties by transfer or to transfer his own products or other properties to the company or to receive loans from the company or to effect any transaction with the company on his own behalf or on that of a third person, he shall obtain the approval of the board of directors. The same shall apply in the case where the company guarantees liability of the director or otherwise effects with a person other than the director a transaction in which interests are contrary between the company and the director.

(2) In the case where there has been the approval under the former clause of the preceding paragraph, the provision of Article 108 of the Civil Code shall not apply.

(3) The provision of paragraph 2 of the preceding Article shall apply mutatis mutandis to the director having effected the transaction of paragraph 1."

Civil Code art. 108 provides the prohibition of acting for oneself and as agent for the other party, or as agent for both parties, in one and the same action. Commercial Code art. 264(2) provides that a director who effected a transaction which comes under the category of business of his company (under art. 264(1) such a transaction requires prior approval of the board of directors) must report important facts of the transaction to the board of directors without delay.
"Article 266.

(1) In the following cases, directors who have done any one of the acts mentioned there shall be jointly and severally liable in effecting performance or in damages to the company, in the case of item (i) for the amount which has been distributed or divided illegally, in the case of item (ii) for the amount of the interests offered, in the case of item (iii) for the amount of loans not yet repaid, or in the case of item (iv) and item (v) for the amount of any damage caused to the company:

(i) Where they have submitted to a general meeting the proposal for the distribution of profits in contravention of the provision of Article 290 paragraph 1, or they have distributed money in contravention of the provision of Article 293.5 paragraph 3;

(ii) Where they have offered the interests on a property in violation of the provision of Article 294.2 paragraph 1;

(iii) Where they have loaned money to another director;

(iv) Where they have effected any transaction mentioned in paragraph 1 of the preceding Article;

(v) Where they have done any act which violates any law or ordinance or the articles of incorporation.

(2) In cases where any act mentioned in the preceding paragraph has been done in accordance with the resolution of the board of directors, the directors who have assented to such resolution shall be deemed to have done such act.

(3) The directors who have participated in the resolution mentioned in the preceding paragraph and who have not expressed their dissent in the minutes shall be presumed to have assented to such resolution.
(4) If the director has effected a transaction in violation of the provision of Article 264 paragraph 1, the amount of the profit acquired due to the transaction by the director or the third party shall be presumed to be the amount of the damage imposed to the company in paragraph 1. Provided that, this shall not apply if the right prescribed in paragraph 3 of the said Article has been exercised.

(5) The liability of directors mentioned in paragraph 1 cannot be released except by the unanimous consent of all the shareholders.

(6) The liability of directors in respect of the transaction mentioned in item (iv) of paragraph 1 may be released by majority of two-thirds or more of the votes of the total number of the issued shares, notwithstanding the provisions of the preceding paragraph. In this case, the directors shall show all material facts as to such transaction at a general meeting of shareholders."

This is the basic provision concerning directors' liability and covers matters other than art. 265 transactions as well. Arts. 290(1) and 293.5(3) set out limitations to distribution of dividend and interim dividend respectively. Art. 294(1) prohibits giving profit to a shareholder in connection with exercise of the voting power.


28 Amended art. 265(1).


33 Re appeal by Hai et al., Tokyo H.C. March 5, 1956, 9 Kominshu 76.


Tanaka v. K.K. Aida Mitsuzo Shoten, S.C. January 28, 1964, 18 Minshu 180 (A company endorsed a promissory note to a director in exchange for his financing the same amount of money to the company); Yagimachi Nogyo Kyodo Kumiai v. Kyoei Rikuun K.K. et al., Osaka H.C. December 23, 1968, 232 Hanrei Times 122 (A company guaranteed its director's loan, but it was in substance to enable the company to borrow from the agricultural co-operative which restricted the qualification of borrower); Sawayama v. Meirin Sangyo K.K., Osaka D.C. January 30, 1973, 715 Hanrei Jiho 102 (A director received a promissory note issued by his company and endorsed it in lieu of guarantee by him for the company).

Arts. 265(3), 264(2).

Art. 498(1)(xx.ii).


Art. 260.2(2)(3).


Unknown v. Unknown, Nagoya D.C. November 14, 1974, 21 Shomu Geppo 575.


48 G.C.J., supra, n. 43.

49 Nihon Victor K.K. v. San'ei Denki K.K., supra, n. 27.

50 Tsuchikida v. K.K. Sengokuya, supra, n. 31.

51 Motoki, op. cit., n. 39, 131.

52 Art. 266(1)(i)(iii)(iv)(v) and (2).

53 Art. 266(5)(6).

54 Unknown v. Unknown, S.C. March 23, 1976, 798 Kinyu Homu Jijo 36 took this view in a different matter which did not involve art. 265.


56 Previous art. 239(5).

57 Art. 247(1)(iii).
D. The Director's Duty of Care, Diligence and Skill

In Canada, efforts have been made to upgrade the low common law standard of the directors' duty of care by statutory reform, whereas in Japan the duty and the standard have been developed by court decisions based on abstract legislative provisions.

1. Canada

(1) Common Law

While courts have developed a strict standard for the fiduciary duty of directors by analogy to the duties of trustees, they have adopted a low standard for the duty of care, diligence and skill of directors.

Romer, J.'s judgement in Re City Equitable Fire Insurance Company Ltd. is the leading case on this point and established three important propositions. First, as to the duty of care, he stated that the care that a director is bound to take is "'reasonable care' to be measured by the care an ordinary man might be expected to take in the circumstances on his own behalf", quoting the decision of Neville, J. in In Re Brazilian Rubber Plantations & Estates Ltd. In this sense,
the standard is objective. However, Romer, J.'s decision limited it by the subjective standard that "[a] director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience."

The Brazilian Rubber case, supra, shows us an extreme example. The directors of the company who were induced to become directors included: A., who was absolutely ignorant of business matters and only consented to act because he was told the directorship would give him a little pleasant employment without his incurring any responsibility; T., a partner in a firm of bankers, who was seventy-five years old and very deaf; B., a rubber broker, who was told that all he would have to do would be to give an opinion as to the value of rubber; and H., a man of business who was induced to join by the presence on the board of T. and B., whom he considered good men. They were held not liable for the losses sustained in a disastrous speculation in rubber plantations on the basis that:

"[A director] is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance."
However, if a director has experience in the area of the company's business, he would be required to use it for the benefit of the company. Further, in *Lister v. Romford Ice and Cold Storage Ltd.*, where an executive director was employed under a service contract, it was held to be an implied term of that contract that the employee would exercise the degree of care and skill to be expected of a person in that position.

Secondly, as to the level of attention a director must devote to corporate affairs, Romer, J. in the *City Equitable* decision set out a generous standard:

"A director is not bound to give continuous attention to the affairs of his company. His duties are of intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so."

This proposition concerns non-executive directors. Officers must give continuous attention to the affairs of the company.

The outcome of the second proposition is that a director who does not attend a board meeting may be in a better position to escape liability for a resolution passed at that
meeting than a director who does attend. In *Re Cardiff Savings Bank*, a director who had not attended any meetings for seventeen years was held not liable. Stirling, J. stated the rationale as follows:

"Neglect or omission to attend meetings is not the same thing as neglect or omission of a duty which ought to be performed at those meetings."

Thirdly, as to the matters delegated to other officials, Romer, J. in the *City Equitable* decision stated:

"In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly."

Then he quoted the decision in *Dovey v. Cory* that a director is entitled to rely on the judgement, information and advice, of the chairman and general manager, as to whose integrity, skill and competence he has no reason for suspicion, and that a director is not bound to examine entries in the company books for himself, notwithstanding they are laid on the table at a meeting of the board for reference.

The foregoing decision of Romer, J. is considered the *locus classicus* on the directors' duty of care. As such, it
has resulted in an almost total absence of cases imposing liability on directors for negligence. The reasons for the courts' reluctance to impose a strict standard of care are explained as follows:

"This reluctance is generally attributed to the fact that directors' decisions are largely matters of business judgment with which courts are reluctant to interfere. In addition, courts are aware that directors are often involved with the company only on a part-time basis and are sometimes elected for reasons other than their business expertise."

In any event, this lax approach does not encourage a high standard of performance of the directors' duty of care, diligence and skill, and is an unduly low standard in the modern business environment.

(2) **Statutory Reform**

(a) **Standard of Duty of Care, Diligence and Skill**

The BCCA, the old and new OBCA and the CBCA have provisions which are intended to upgrade the low common law standard. They expressly demand that every director or officer in exercising his powers and performing his duties shall exercise the care, diligence and skill of a reasonably
prudent person. Except in the BCCA, this standard is qualified by a phrase "in comparable circumstances". It is likely that a court would read such a phrase into the BCCA provision in deciding the facts of a particular case.\textsuperscript{12}

In drafting the old OBCA provision, the Lawrence Committee proposed that the standard be that of the "reasonably prudent director", in the hope that the courts would develop professional standards for directors.\textsuperscript{13} However, it caused an uproar from the corporate bar, which was successful in having the wording changed from "prudent director" to "prudent person".\textsuperscript{14} One of the draftsmen states that "this change in terminology effects no change in the intention or meaning of the new section",\textsuperscript{15} but this proposition is questioned.\textsuperscript{16}

It should be noted that the BCCA, the new OBCA and the CBCA have provisions which will relieve a director from liability under certain circumstances, e.g. when he relied in good faith on financial statements supplied by an officer or an auditor.\textsuperscript{17} The BCCA provision applies only to specific statutory liabilities, while the new OBCA and the CBCA provisions also apply to the general duty of care.

In addition, the BCCA provides that in any proceedings against a director and an officer, if it appears to the court
that he is or may be liable in respect of negligence, default, breach of duty or breach of trust, but acted honestly and reasonably and ought fairly to be excused, the court shall take into consideration all the circumstances of the case, including those connected with his appointment. Then the court may relieve him, either wholly or partly, from his liability on the terms the court considers necessary. But the adequacy of such a provision is seriously questioned.

Whether the courts will apply the new provisions on the standard of performance of the duty of care so as to upgrade the low common law standard is questionable. In light of the experience in the U.S., a pessimistic observation has been made:

"If the American decisions are any guidance, the degree of care, diligence and skill enjoined on the incumbent [in the old OBCA and the CBCA] would appear to do little to raise the low standards imposed by the common law on non-professional directors. Perhaps this is inevitable given the diversities of background and experience from which such persons are drawn and the many calls in their time. These are the factors, rather than a lack of prudence, which often account for their disappointing performance in practice."
(b) **Deemed Consent**

A significant development was made by provisions which prevent a director from relying on absence from meetings to escape liability. The BCCA, the old and new OBCA and the CBCA provide that if a director was absent from a meeting at which a resolution was passed or an action was taken, he is deemed to have consented to it unless he submits his dissent within seven days after he becomes aware of the resolution or action.\(^{21}\)

The deemed consent in the BCCA and the old OBCA is limited to specific matters such as the improper declaration of a dividend. The CBCA provision is better in that the deemed consent is applicable to any resolution or action at a meeting of directors or a committee of directors. The new OBCA followed this position. However, the phrase "after he becomes aware of the resolution" may limit the effectiveness of the provisions. A director who does not bother to read minutes or notices could presumably escape liability.\(^{22}\)

(c) **Specific Statutory Liabilities**

In addition to the foregoing general standard, the BCCA, the old and new OBCA and the CBCA all have extended the specific statutory liabilities of directors and officers
relating to corporate mismanagement. The activities giving rise to liability under the legislation range from the improper declaration of a dividend to unpaid wages of employees. Most of them concern the protection of the corporate fund. However, for the purpose of this study, it will not be necessary to go into details about them.²³

(d) Liability of an "Agent" in the New Bankruptcy Act²⁴

A further attempt is made to increase the liability of directors for improper commercial conduct by the "agent" provisions in the proposed new federal bankruptcy legislation.²⁵ In respect of a corporation, the definition of agent includes a director or an officer of a corporation, or any person who is related to the corporation or who has, directly or indirectly, de facto control of the corporation.²⁶

An agent is liable for the deficit of the bankrupt corporation if he has acted in his own pecuniary interest or in the interest of someone related to him and has caused the corporation, when insolvent, to do certain conduct proscribed in the new Act.²⁷ The first category of such conduct is to carry on a business or enter into a transaction that was contrary to the pecuniary interest of the corporation, or to refrain from carrying on business or entering into a
transaction that was in the pecuniary interest of the corporation.

The second category is to continue a business by resorting to sales below cost to the detriment of the creditors, or ruinous borrowings or similar acts in circumstances where it was not reasonable to expect that the bankruptcy could be prevented and where those acts aggravate the insolvency of the corporation.

The third category is to conduct a business with a view to defrauding or delaying the creditors.

Further, if an agent fails to keep accounts in a manner that permits the trustee to distinguish the property of the agent from that of the corporation which subsequently becomes bankrupt, he is liable for the deficiency in the estate.28 The liability of an agent can be reduced to the extent that it is proved that the amount of loss or damages caused to the estate by him is smaller than the amount of the deficiency.29

In addition to the foregoing liability, an agent may be subject to the severe consequences of a caveat. The administrator may inquire into certain circumstances which are
broader than the causes of liability. The prescribed circumstances include, for example, failure to keep proper business records, incurring of an unjustifiable expense by the taking or continuing of frivolous or vexatious proceedings, gambling, wagering, gross incompetence or carelessness, extravagant expenses or rash speculation. When an administrator has reason to believe that an agent may be liable under ss. 189 or 190, or that any of the causes giving rise to an investigation as set forth in s. 215, are attributable to an agent, the administrator may, within one year from the date of bankruptcy of the corporation, file a caveat with respect to the agent. Until the caveat is discharged, it is prohibited for the agent, without leave of the court, to (i) be a director or an officer of, or manage, a corporation, and (ii) engage in or carry on any business without disclosing the existence of the caveat to all persons with whom he incurs debts in the course of such transaction or business. The caveat will expire five years from the date of issuance. This system will be useful for upgrading the duty of care indirectly.
2. Japan

(1) Statutory Provisions concerning the Duty of Care

With respect to the stock corporation, the Commercial Code provides that the relations between directors and the company are governed by the provisions concerning mandates. The Civil Code provides that a mandatory is obliged to exercise the "care of a good manager". Therefore, this is the general standard of care of directors.

Under the Civil Code, there are two degrees of duty of care. The care of good manager is the higher standard which is applicable to a mandatory, a bailee for reward, a person having a right of retention, a pledgee, and a guardian. In contrast, the "same care as he uses on his own behalf" is the lower standard which is applicable to a gratuitous bailee, a person who exercises parental power, and a successor.

However, this abstract standard does not give an immediate answer when applied to company directors. The substance of the standard was created by court interpretations.

Before going into the discussion, some preliminary explanations seem to be necessary. The first is the third
party liability provision. Art. 266.3(1) of the Commercial Code provides that directors are jointly and severally liable to a third party for damage caused intentionally or by gross negligence in performing their duty.36 The meanings of this provision caused a lot of confusion among courts and commentators. The Supreme Court decision in Senbi Kozai K.K. v. Muto37 settled basic issues concerning this provision. According to the decision, this provision is intended to protect a third party. If a director breached his duty which he owes to his company intentionally or by gross negligence, he is liable to a third party, regardless of whether the third party suffered damage directly from his breach of duty, or indirectly as a result of the damage which the director caused to his company, so long as a reasonable causation exists between his breach of duty and the third party's damage. Therefore, the injured third party is not required to prove that the director intended or should have foreseen his damage, so long as the causal link exists. The party must prove intentional or foreseeable harm if he claims damages under the ordinary tort provisions.

Almost all cases in which directors have been held liable for breach of duty of care were brought under this provision by creditors of financially collapsed companies. The courts have been rather strict toward directors and this provision has been a powerful weapon for creditors.
Secondly, there is an express provision which presumes a director's consent to a decision of the board of directors. However, this is applicable only to a director who attended a board meeting but did not cause his dissent to be entered in the minutes. As discussed below, in order to condemn directors who do not attend meetings, the courts inferred a duty to monitor the execution of corporate affairs from the duty of care.

Thirdly, there are provisions concerning specific statutory liabilities of directors. However, in the following discussion I will focus on the general duty of care.

(2) **Duty of Care concerning Corporate Business**

Business management necessarily involves some risks. Therefore, directors should be allowed to exercise a reasonable discretion and should not be held liable simply because their decisions result in loss or damages to the company. This logic is stated in several inferior court decisions.

However, there are a number of cases in which directors were held liable for mismanagement which caused the collapse of their companies. As it is impossible to catalogue all of them here, I will draw on some examples.
(i) A representative director continued with, and even increased the level of, transactions with a customer despite the fact that he was well aware of the extreme financial difficulties being experienced by the customer and that the unpaid debts of the customer to his company kept increasing. This conduct increased his company's loss. He was found negligent and therefore liable to his company for the loss. The Tokyo High Court rejected the defendant's argument concerning the director's right to exercise business judgment in connection with risks in business activities, on the grounds that the negligence in this case could have been easily avoided. 41

(ii) A company's payment to its suppliers depended on the payment of promissory notes issued by its major customer. Although the representative director of the company discovered the financial difficulty of the customer, he desultorily continued the transactions with it without taking any action to avoid its possible bankruptcy. The customer shortly afterwards went bankrupt and the company subsequently became unable to pay the
suppliers. The Tokyo High Court, while acknowledging that the courts should be careful of the possibility of harming the discretion or elasticity of business management by condemning a director too easily, found that the director in this case was extremely unreasonable and thus grossly negligent.\textsuperscript{42}

(iii) A representative director issued a promissory note on behalf of his company to another company which was already bankrupt for the purpose of giving it a credit. Such conduct was held to be gross negligence in the absence of special circumstances which would ensure the settlement of the note by the bankrupt company.\textsuperscript{43}

(iv) A representative director obtained finance by issuing promissory notes, expecting that it would be possible to pay them off by expanding the business and increasing the income, without having any clear foresight or policy concerning the business. He then made a huge investment in another company which he did not investigate sufficiently, without considering the assets and capacity of his company. The bankruptcy of the
other company caused the collapse of his company. It was held that he acted in an extremely loose-spending manner, and thus he was found grossly negligent. 44

(v) A representative director who raised funds by transferring promissory notes to a third party when his company was about to go bankrupt was held grossly negligent. 45

(vi) A representative director who ordered advertisements at considerable cost in spite of the extremely poor financial status of his company, was found to have exceeded the bounds of reasonable discretion and thus to be grossly negligent. 46

(vii) Two directors planned to construct golf links and they recruited members, although they did not have any experience in that business. They faced financial difficulty, could not even purchase the requisite site, and abandoned the plan. They were held grossly negligent and thus liable for the amount of membership fees they had collected. The court's reasoning was that they commenced the
plan without sufficient investigation or a reasonable plan to raise the necessary funds, simply swallowing the explanation of the local people. 47

The foregoing is only a selection from a number of cases which have held representative directors liable for mismanagement. However, there is one case in which an overly strict decision of a lower court was reversed. In Tsuboi v. Yajima, 48 a contractor company went bankrupt due to the bankruptcy of the subcontractor to which the company had extended loans. The Supreme Court held that the original decision was wrong in holding the representative director liable for loose-spending loans to the subcontractor only on the grounds that the amount of the loans exceeded the amount of the order taken by the subcontractor at the time of its bankruptcy. The Supreme Court suggested that it was necessary to consider the factors such as when the subcontractor's inability to make payment was foreseen or could have been foreseen, whether the loans were made after that date, and how much money was lent.

In short, it may be said that the Japanese courts expressly or impliedly recognize that directors who manage corporate business are entitled to exercise some discretion in
making business decisions. However, the courts often hold them liable for mismanagement in corporate bankruptcy cases and do not hesitate to scrutinize the adequacy of their business decisions in concrete cases to establish liability.

(3) Duty of Care with respect to Monitoring the Execution of Corporate Affairs

The foregoing is the liability of directors who are actually managing corporate business activities. The next question is the liability of other directors who fail to prevent the breaches of duty of the errant directors. In order to hold them liable, the courts read a duty to monitor the execution of corporate affairs into the duty of care.

First, the duty was established with respect to representative directors. After a line of inferior court decisions upholding this duty, the Supreme Court, in Senbi Kozai case, held that:

"...Since a representative director is an organ which has the power and duty to represent the company externally and manage the execution of overall corporate affairs internally, it goes without saying that he is obliged to perform his duty faithfully for the company with the care of a good manager and pay attention to the overall corporate affairs. Therefore, at least, if a representative director left all corporate affairs to another representative director or others without paying any attention to their execution of corporate affairs, and eventually
overlooked their wrongdoing or breach of duty, it is reasonable to consider that he himself also breached his duty through *mala fide* or by gross negligence."

In this case, a representative director (A.) purchased goods and issued a promissory note to pay for them although the financial condition of his company was extremely bad and its inability to pay the note could have been foreseen easily. Another representative director (B.) who had been appointed by virtue of his fame and credibility, was busy with his own business and left the corporate affairs entirely to A. Both A. and B. were held grossly negligent.

Secondly, the duty to monitor was established with respect to ordinary directors. Undoubtedly they are obliged to pay attention to the matters brought to the meeting of the board of directors. The question was whether they were bound to pay attention to other matters, e.g. wrongdoing of the representative director which is not disclosed at the board meeting. At first, inferior courts denied the existence of such a duty. Later, some decisions upheld the duty. Finally this matter was settled affirmatively by the Supreme Court in *Kobayashi et al. v. Hashimoto et al.* In this case, A., B. and C. formed a company to combine their respective businesses, i.e. sales of electric appliance by A. and repair of the same by B. and C. A. became a representative director and B. and C.
ordinary directors. B. and C. were engaged in the repair business and left all corporate affairs to A. A. managed the company at his sole discretion and held no shareholders' meetings or board meetings. A. planned to expand the business to include automobile repairs, without consulting the other two, and issued an excessively large promissory note to obtain finance. As he lost the note by fraud and could not obtain the proceeds, the company went bankrupt. The court of second instance held that B. and C. were grossly negligent in not paying attention to corporate affairs and in not preventing the issuance of the excessive note by A. The Supreme Court affirmed, saying that:

"Inasmuch as the board of directors is in a position to supervise the execution of corporate affairs, it should be held that the directors who comprise the board of directors have a duty to the company not only to monitor the matters brought to the board meetings, but also to monitor the representative directors' execution of corporate affairs in general and, if necessary, to convene a board meeting themselves or request it to be convened, and to see that the execution of corporate affairs is done properly through the board meeting."

The defendants argued that so far as A. secretly did the act in question, there was no reasonable causation between A.'s act and their inattention, but the Supreme Court simply rejected the argument.
Those Supreme Court decisions accelerated the art. 266.3 claims by allowing creditors to condemn the directors' inaction which allowed mismanagement by other directors.

(4) The Duty of Nominee Directors

There are many occasions in which representative directors and ordinary directors are appointed merely as nominee directors and pay no attention to the conduct of the director who actually manages the company. When they are sued, they try to escape liability asserting that they are only nominee directors. The courts have not been sympathetic with them. In the Senbi Kozai case, the Osaka High Court acknowledged the fact that the representative director assumed his office only because he was told that his position would be nominal and he would not incur any responsibility. Nevertheless, the court flatly said that this was no defence to his breach of duty to monitor the execution of corporate affairs. This point was impliedly affirmed by the Supreme Court. There are other inferior court decisions which hold the nominee directors liable.

There are cases in which a defendant tries to escape liability by alleging that he has not been a director from the outset and that the corporate registration form indicating his
assumption of office is false. The Supreme Court, in *K.K. Nihon Studio v. Nakamura*,\(^5\) rejected such a defence by following reasons: Art. 14 of the Commercial Code provides that a person who intentionally or negligently registers false matters is prevented from asserting that those matters are false as against a *bona fide* third party. As to the false registration of directors, the party who is estopped by this provision is not the person indicated as director, but the company which effected the registration. However, the Supreme Court applied the provision by analogy to a person who consented to the false registration of his assumption of the office of a director. Therefore, he was held liable under art. 266.3 of the Commercial Code for not monitoring the execution of the corporation's affairs and not preventing a loose-spending loan by the person who actually managed the company, just as if he had been a real director.

(5) **Limitations on the Duty to Monitor**

Recently there have been an increasing number of inferior court decisions which have held directors not liable for breaches of the duty to monitor. The following are a sample of those decisions:

(i) a representative director in charge of accounting
(A.) committed fraud and caused damage to third
party. Another representative director in charge of marketing (B.) was found in breach of his duty to monitor A.'s conduct. But the court held that his breach did not amount to the gross negligence required under art. 266.3, because it was difficult for B. to know of A.'s fraud, and the financial statements which were submitted by A. to the management committee and examined by B. did not suggest the company was in financial difficulty.  

(ii) A director's inattention to corporate affairs was held not to be gross negligence, because he was taking a rest due to illness and was not involved in the management of the company, and he did not have an opportunity to know the situation of the management of the company as no shareholders meeting or board meeting was held.  

(iii) A company's management was dominated completely by a representative director (A.). A. induced the oldest employee (B.) to become a director, saying that it was to fulfil the quorum of directors and it would cause no trouble to B. B. continuously engaged in simple work under the
direction of A. No board meeting was held and B. had never been involved in financial affairs of the company. B. had no education other than that of elementary school, had no knowledge concerning accounting books or bank transactions, and was totally ignorant of the duties of a director. A. and another director in charge of accounting obtained finance by deceiving a bank as to the financial condition of the company. Although the court found B. to be negligent for his failure to monitor the corporation's affairs, he was held not to be grossly negligent.56

(iv) A company had one representative director (A.) and two directors (B. and C.). B. was A.'s wife. C. was a licensed investigator of lands and houses but had no knowledge about the business of the company. C. was induced by A. to become a director as he was a relative of B. C. made no capital contribution, nor did he receive any remuneration. The company was managed solely by A. No board meeting was ever held. Every month C. received A.'s oral report about the company's business. The financial condition of the company declined and finally it went
bankrupt. However, A. had constantly informed C. that the business was in good condition. The court found that C.'s failure to use stronger supervision and intervention was a breach of his duty to the company, but it denied his conduct amounted to gross negligence in light of his limited position. In addition, the court indicated its doubt about the existence of reasonable causation, because even if C. had received the report on the financial status of the company, he could have done nothing but trust A.'s optimistic comments. 57

There are other recent cases which set out generous standards for nominee directors. 58 It seems that inferior court decisions are moving towards subjective standards comparable to the common law standard, particularly with respect to nominee directors. However, there still are cases which have refused to give a lower standard to nominee directors. 59

Recently in Daido Sanso K.K. v. Suga, 60 the Supreme Court reversed the original lower court decision which negated a nominee director's duty to monitor another director's execution of corporate affairs. In this case, A. was a
representative director of a company and B. occupied the corresponding position in a customer company. At the request of A., B. subscribed to one-fifth of A's company's shares and became its nominee director. B. left the corporate affairs entirely to A.'s sole discretion and did not monitor his conduct at all. A. purchased goods when there was no possibility of payment and caused damages to the seller. The Supreme Court held that an ordinary director's duty to observe the execution of corporate affairs established in Kobayashi et al. v. Hashimoto et al. is also applicable to a nominee director such as B. Secondly, the Supreme Court found the original decision to be wrong in holding that B. was in fact unable to prevent the purchase by A. The court suggested that B. had not a little influential power over A., and ordered a retrial of the case.

Unfortunately this decision did not clarify to what extent the courts may take into consideration subjective factors, such as the circumstances surrounding a director's appointment. The standard of care developed by court interpretations is still fluid.

(6) 1981 Amendment to the Commercial Code

In the course of drafting the 1981 amendment to the company law provisions in the Commercial Code, a request was
made to make the conditions for third party liability under art. 266.3 more specific, in light of the confusion in the court decisions. However, it was felt too early to enact more specific rules, and it was decided to wait for further developments in the court cases.  

A significant development was the legislative decision to increase the supervisory power of the board of directors. Firstly, the old Commercial Code was interpreted so as to mean that the board of directors had a power to supervise the directors' performance of their duties. In the 1981 amendment, a provision expressly stating this power was enacted, in the hope that directors would become more conscious of their monitoring function.  

Secondly, under the old Code, the extent to which the board of directors could delegate their power to a representative director was unclear. The amended Code now provides that the board of directors has the power to determine important corporate affairs which they cannot delegate to directors (whether representative directors or not). The new provision sets forth some examples of important corporate affairs, such as disposition and acquisition of important property, or a loan of a large amount, but the list is not exhaustive.
Thirdly, to facilitate the supervisory function of the board of directors, the amended Code imposes on directors the duty to report to the board of directors on the execution of corporate affairs at least once every three months.65

Fourthly, under the old Code, each director had a power to convene a board meeting, except that the board of directors designated a particular director to do so.66 If the designated director refused to convene a meeting, it was unclear whether or not other directors were entitled to do so. The amended Code has new provisions that each director may request the designated director to convene a meeting, and that if he does not do so within a specified period, the director making the request may convene the meeting himself.67

The foregoing is another example of law reform in Japan. The courts develop rules by creative interpretation of simple statutory provisions. But this process is time-consuming and involves uncertainty. Before the Supreme Court renders a decision on a certain issue, there are conflicting inferior court decisions. The Supreme Court decision is not necessary clear enough to settle the issue completely. Legislators are wary of interfering with this procedure.
FOOTNOTES (D. The Director's Duty of Care, Diligence and Skill)

1 In doing research on this topic, I am indebted to Toriumi, Directors' Duty of Care, Diligence and Skill: Comparative Study of Japanese and Canadian Law, unpublished thesis submitted to the University of British Columbia, Faculty of Law (1983).

2 [1925] Ch. 407.

3 [1911] 1 Ch. 425.

4 Ibid., 437.


7 [1892] 2 Ch. 100.


9 Beck et al., Business Associations Casebook (1979), 215.

10 Iacobucci et al., Canadian Business Corporations (1977), 287.

11 BCCA s. 142(1)(b); old OBCA s. 142; new OBCA s. 134(1)(b); CBCA s. 117.

12 Iacobucci et al., op. cit., n. 10, 290.

13 The Report of the Ontario Select Committee on Company Law (Lawrence Report), paras. 7.2.3 and 7.2.4.

14 Beck et al., op. cit., n. 9, 216.


17 BCCA s. 151(9); new OBCA s. 135(4); CBCA s. 118(4).

18 BCCA s. 226.

19 Iacobucci et al., op. cit., n. 10, 332.

21 BCCA s. 151(6); old OBCA s. 135(3); new OBCA s. 135(3); CBCA s. 118(3).

22 Iacobucci et al., op. cit., n. 10, 293

23 For further details, see ibid., 321-328.

24 For more detailed discussion, see Marantz, "Current Trends in Canadian Bankruptcy Law", Special Lectures of the Law Society of Upper Canada (1982), 659, 678-680.


26 S. 2(1).

27 S. 189.

28 S. 190.

29 S. 191.

30 S. 215.

31 S. 218.

32 S. 224.

33 S. 219(9).

34 Art. 253(3).

35 Art. 644.

36 Commercial Code art. 266.3 provides as follows (translation in 2 EHS Law Bulletin Series No. 2200, slightly modified by the author):

"Article 266.3

(1) If directors have been guilty of wrongful intent or of gross negligence in respect of the assumption of their duties, they shall be jointly and severally liable in damages to third persons also.

(2) It shall be the same to the preceding paragraph if the director has made a false entry as to the important matters to be stated in the application for shares, certificate for
pre-emptive right, application for debenture, or
the prospectus or in the documents of Article 281
paragraph 1, or made a false registration or
public notice. Provided that, this shall not
apply in the case where the director validated
that he was not negligent of care to making the
entry, registration or public notice.

(3) The provisions of Article 266
paragraphs 2 and 3 shall apply mutatis mutandis
to the cases mentioned in the preceding two
paragraphs."


38 Commercial Code Art. 266(3).

39 See Commercial Code art. 266(1) quoted in supra, Section C,
n. 26. In addition, there are following provisions: arts.
280.13(1) (lack of subscription of new shares), 293.5(5)
distribution of interim dividend which results in
insufficient net assets of the company at the end of the
fiscal year).

40 Bankrupt: San'ei Byora K.K.; Trustee of Bankruptcy: Tanaka
v. Misaka et al., Osaka D.C. April 20, 1967, 498 Hanrei
Jiho 64; Azuma Kozai K.K. v. Saigusa, Tokyo H.C. January
29, 1975, 771 Hanrei Jiho 77; Kitahara v. Ohashi et al.,
Toyo D.C. March 2, 1978, 909 Hanrei Jiho 95; Daiwa Kogyo
Hanrei Jiho 161.

41 Nisshin Shirring K.K. v. Funaki, Tokyo H.C. January 29,
1970, 21 Kaminshu 118, afmd., S.C. April 25, 1972, 670
Hanrei Jiho 45.


43 Unknown v. Unknown, S.C. October 26, 1976, 813 Kinyu Homu
Jiyo 40.


45 Takagi v. Yoshioka et al., Osaka D.C. October 30, 1979, 954
Hanrei Jiho 91; Saotome Shokai v. Makita, Tokyo D.C.
December 21, 1979, 961 Hanrei Jiho 113; Teraji v. Saito,
Tokyo H.C. June 30, 1980, 973 Hanrei Jiho 120.

46 K.K. Sanpo v. Fujino, Tokyo D.C. February 24, 1978, 906
Hanrei Jiho 91.


49 Supra, n. 37.


61 Supra, n. 50.

63 Art. 260(1).
64 Art. 260(2).
65 Art. 260(3).
66 Art. 259; now Art. 259(1).
67 Art. 259(2)(3)
E. Lifting the Corporate Veil

In Anglo-Canadian law, the courts have been wary of disregarding the separate existence of a company as distinguished from its members. This is particularly true when the limited liability of shareholders is at stake.\(^1\) Conversely, most of the cases in which the Japanese courts used the doctrine concern the imposition of corporate debts on shareholders or related companies.\(^2\) Therefore, in comparing the Canadian approach and the Japanese equivalent with respect to this doctrine, I will focus on the issue of limited liability.

1. Canada

   (1) Principle of Salomon Case

   In Canada, as well as in England, with respect to the limited liability of shareholders, the courts have rigidly applied the principle established in *Salomon v. Salomon & Co.*\(^3\) and its corelative propositions. Namely, a company is a legal entity distinct from its members, and its property, rights and liabilities are not those of the members. Even if it is a "one man company", the company is not an alias for the owner. In the absence of fraud or improper conduct, the courts cannot disregard the separate existence of a corporate entity.
Therefore, as shown in the Salomon case, an individual who operates a business through his company can use the limited liability of a shareholder as a shield from the debts arising from the business, even if it is his one man company.

Similarly, the creditors of a shareholder cannot have access to the assets of a company owned and controlled by him by alleging that the company is a mere agent and the alter ego of the shareholder.\(^4\)

(2) Some Solutions

The rigid adherence to this principle may create inequitable results for creditors of a company. Therefore, while not altering the principle itself, the courts and legislators have attempted to mitigate the inconveniences created by the separate legal entity. Regulations concerning preservation of corporate funds contained in company legislation are one such countermeasure. However, in the discussion below, I will only mention some selected matters.

(a) Identification of the Party to a Contract

The "one man company" often makes the contracting party ambiguous. There are many cases in which the sole owner
of the company enters into a contract without making it clear that he is acting as agent for the company, and later alleges that it is not he but his company that is liable under the contract. The courts have solved this problem as a matter of identification of the party to the contract. I will cite only recent cases.

In order to protect the other party to the contract, the courts use the doctrine of the undisclosed principal; i.e. when an agent enters into a contract in his own name, he is personally bound by the contract. The other party may sue either the agent or the principal who was later discovered, but the agent cannot escape liability by the fact that the principal may also be added as a party. Therefore, an owner of a company who signed a contract without qualification is personally liable, and cannot escape liability by saying that he intended to act as agent for his company.  

There is an obligation upon a party who intends to rely on the fact of incorporation to claim limited liability protection to give notice to the other party. There are cases in which an individual defendant was held personally liable due to the failure to prove that the other party was aware that he was contracting with a corporation, despite some dubious facts; e.g. payments were made by company cheques, or the plaintiff received timebooks bearing a company name.
Further, there is a case which held that an individual defendant had pledged his own credit by his acts, and impliedly had agreed to pay personally.\textsuperscript{8} In another case, a person who entered into a contract and continuously engaged in dealings personally, intended to substitute his company for himself as party to a contract. But he was held to be still liable, as his notice to the other party was insufficient and the subsequent dealings were done in the same manner as before.\textsuperscript{9}

A similar problem occurs between two interrelated companies. In *Keewatin Electric & Diesels Ltd. v. Durall Ltd.*,\textsuperscript{10} an officer of both the defendant company (D. Co.) and another company (A. Co.) requested the plaintiff to repair machinery. He drove the machinery to the plaintiff in D. Co.'s truck, and he answered the telephone when the plaintiff telephoned D. Co. The work order was taken from the books of A. Co., and part payment was made by A. Co.'s cheque. When sued by the plaintiff for the balance payment, D. Co. alleged that A. Co. was liable for it. It was held that when two interrelated companies worked from the same office there was a heavy onus on the officers to prove they were dealing in the name of one company or other, and that D. Co. was liable as it had not discharged the onus.
It should be noted that BCCA s. 130 provides the specific liability of a director or officer who violates the duty to display the name of his company.

However, once it is established that the other party was aware that he was dealing with a company, it is no longer possible to hold the owner of the company liable. In fact, the Salomon decision, supra, said:

"The unsecured creditors of A. Salomon and Company, Limited, may be entitled to sympathy, but they have only themselves to blame for their misfortunes. They trusted the company, I suppose, because they had long dealt with Mr. Salomon, and he had always paid his way; but they had full notice that they were no longer dealing with an individual..."

In Rockwell Developments Ltd. v. Newtonbrook Plaza Ltd., the plaintiff company (R. Co.) lost case which concerned the transfer of land. The trial judge ordered the owner (K.) of the company to pay the costs, on the basis that K. was the actual contracting party and the actual litigant, and that R. Co. was only a nominee to hold title. In the absence of an allegation against K. of any misconduct, the Ontario High Court overruled the order. The court was not persuaded to depart from the traditional principle by the fact that there was nothing in R. Co.'s corporate records respecting the transaction, no directors' resolution was passed as to the
transaction and the litigation, and K. and his partner directly advanced the deposit for the transaction and paid the fees to R. Co.'s solicitors.

What if the owner of companies deliberately has misled the other party as to the identity of the company he was dealing with? In *Pacific Rim Installations Ltd. v. Tilt-up Construction Ltd. et al.*,

What if the owner of companies deliberately has misled the other party as to the identity of the company he was dealing with? In *Pacific Rim Installations Ltd. v. Tilt-up Construction Ltd. et al.*, T., the principal of T. Co. and C. Co., caused T. Co. to enter into a contract with a third party with respect to the construction project. He caused the plaintiff to enter into a subcontract with C. Co. by pretending that C. Co. was the proper party to deal with. The owner made payment to T. Co. but T. did not pay it to the plaintiff. The court held that in order to prevent this unconscionable manipulation by T. to avoid the payment of the plaintiff's claim, the corporate veil should be lifted and the companies should be recognized as T.'s alter ego, and therefore both companies were jointly liable.

(b) *Anti-fraud Provisions concerning Winding-up*

The BCCA, the old and new OBCA and the CBCA have special anti-fraud provisions which are applicable in cases of winding-up. The BCCA provides that in the course of the winding-up of a company, where it appears that any person who
has taken part in the formation or promotion of the company or any past or present director, officer, receiver, receiver manager, liquidator or member of the company has misapplied, or retained, or become liable or accountable for, any money, or property, or breach of trust, in relation to the company, the court may examine the conduct of such a person on application of certain specified persons, including a creditor. Then the court may compel such a person to repay or restore the money or property or contribute the sum to the assets of the company by way of compensation in respect of such misconduct. A similar provision in the old OBCA, which remains the same in the new OBCA, extends to misfeasance.

The equivalent provision in the CBCA may be used to attack the misconduct of any person. However, the specified misconduct is limited to concealment, withholding and misapplication of corporate property, and only a liquidator may apply to the court.

(c) Bankruptcy Act

The Bankruptcy Act\textsuperscript{15} has some provisions which may be used against improper conduct by use of of a separate corporate entity. It is impossible to catalogue them exhaustively in this limited space. Instead, I will show some
examples in which fraudulent transactions between a bankrupt company and its shareholders or related companies were successfully attacked by invoking provisions of the Act.

In Re Appleby Estates Ltd.,\textsuperscript{16} the bankrupt company resolved to pay a death benefit to the substantial shareholder. It was applied to reduce her debt to the company. It was held to be a "transfer of property" under s. 73 of the Act. In Re Imperial Broadloom Co.; Trustee v. Shkony and Baruch,\textsuperscript{17} a dividend was declared to forgive the debts of the shareholders to the company. It was held to be a "payment" under s. 79 of the Act.

The "reviewable transaction" mechanism is noteworthy.\textsuperscript{18} It is primarily designed to apply to transactions involving associated companies or a closely held corporation and its officers or shareholders where an undue benefit is conferred on the one party to the ultimate detriment of creditors of the debtor.

A transaction between parties other than at arm's length is a reviewable transaction. Related persons as defined in the Act are deemed not to deal with each other at arm's length while so related. Where a person (including a corporation) who has sold, purchased, leased, hired, supplied or
received property or services in a reviewable transaction becomes bankrupt within twelve months of the transaction, the court may inquire into whether the bankrupt gave or received fair market value in consideration for such property or services. If it is found that the consideration was conspicuously greater or less than the fair market value, the court may give judgment to the trustee against the other party to the transaction and/or any person who is privy to the transaction with the bankrupt, for the difference between the actual consideration given or received by the bankrupt and the fair market value. The onus of proof is reversed in that the court is bound by what is stated by the trustee as the fair market value and the actual value in question, unless other values are proven.

For example, in Rustop Ltd. v. White et al., B. and W. were the only directors of R. Co. and B. Co. They were sole shareholders of B. Co., which owned 33% of R. Co.'s shares. The balance of 67% was owned by them. They caused R. Co. to forgive the debt of B. Co. to R. Co., for which R. Co. received no consideration. Later R. Co. went bankrupt. It was held that forgiveness of the debt was a reviewable transaction, and B., W and B. Co. were ordered to pay the amount of the debt. In H. R. Doane Ltd. v. Acadia Automotive & Industrial Supplies Ltd. et al., the principal officer of both the
bankrupt company and a sister company effected an undervalued transfer of assets from the bankrupt company to the sister company, and further to a third company which had sufficient knowledge of the entire transaction, before the company went bankrupt. The officer and the third company were ordered to pay the fair price.

The provisions concerning "agent" in the proposed new bankruptcy legislation is another significant step in imposition of personal liability. It has been discussed in Section D concerning directors' duty of care.

2. Japan

(1) Rise of the Doctrine

Contrary to the situation in Canada, the Japanese equivalent of the doctrine ("hojinkaku hinin no hori"; i.e. the doctrine of disregard of the corporate entity) is often used by the Japanese courts to hold the principal shareholders or related companies liable for corporate debts.

The leading case is the Supreme Court decision of 1969 in Hoshihara v. K.K. Yamayoshi Shokai, although it is not a typical case of imposition of debts on the shareholder. Before
that, the doctrine developed in the U.S. was introduced to Japan by a small number of scholars. There were only a few inferior court decisions which upheld the doctrine. The majority of commentators were skeptical about this unfamiliar doctrine. However, when the case was brought to the First Petty Bench of the Supreme Court, of the five judges of the Bench two were vigorous advocates of the doctrine: namely, Jiro Matsuda, a career judge, and Ken'ichiro Osumi, a former professor. Both of them had high reputations in the study of the company law. It is no wonder that the Supreme Court surprised academics and practitioners by forcibly upholding the doctrine.

The case seems to deserve a brief summary here. The plaintiff (H.) was a small merchant, and lent a store building with living space to an electric appliance shop. The shop was run by the defendant company (Y. Co.), of which K. was a representative director. It was his one man company, and in substance was nothing but his personal business. Being unfamiliar with the law, H. did not clearly recognize whether the shop was operated through a corporate form or as a personal business, when he agreed to lease the store. Although the signature of the lessee on the lease agreement was given under the corporate name, later K. executed a memorandum confirming the termination date under his own name. As K. failed to
vacate the premises, H. sued K. as lessee. In the court-supervised settlement, K. agreed to vacate the premises, without questioning the indication of lessee in the agreement. Subsequently, K. refused to vacate the premises alleging that the lessee was Y. Co. Now H. sued Y. Co. as lessee.

The first and second instance courts held that Y. Co., acting through K., had also agreed to vacate the premises in the settlement. However, the Supreme Court relied on the more drastic theory, i.e. the doctrine of disregard of the corporate entity. (This is contrary to the Salomon case in which the House of Lords fiercely negated the original decision which had lifted the corporate veil.) The Supreme Court said:

"It is needless to say that in the case of an incorporated association, the corporation and its members are separate entities distinct from each other under the law, and it is also true in the case in which there is only one member. However, the grant of corporate entity is a matter of legislative policy made by examining the value of socially existing associations. When it is considered to be worthwhile bringing such associations into existence as subjects of rights, the grant is effected based on legal techniques.

Therefore, where the corporate entity is nothing but a shell, or is abused to circumvent the application of law, we should say that the award of the corporate entity should not be permitted in light of the fundamental purpose of the corporate entity, and there may be cases in which disregard of the corporate entity is required. Concerning this point, the following situation must be considered particularly with respect to stock corporations."
As a stock corporation can be easily incorporated under the principle that incorporation is a right only requiring completion of formalities, and even a so-called "one man company" is possible, the situation arises where the form of stock corporation is a mere straw dummy, so to speak; the company is equal to the individual, and the individual is equal to the company; and the substance of the company is perceived as a pure personal business. In such a case, it often becomes ambiguous for the other party entering into a contract with a company, whether the transaction was done as a company or as an individual, and the protection of the other party is necessary. Then, we acknowledge the following: namely, in that case, where it becomes necessary to pursue an individual as in substance existing behind the legal form of a company, even if the transaction was done under the name of a company, the other party can treat the transaction as that of the individual and hold him liable as if there was no corporate entity, by disregarding the corporate entity of the company. Also, in that case, even if the act was done under the name of the individual, the other party can instantly treat it as that of the company, without relying on Commercial Code art. 504 [i.e. the provision similar to the doctrine of undisclosed principal]. This is because the other party's interest would be unjustly injured by the individual's use of the corporate form, if it is not so considered."

Under this proposition, the Supreme Court held that inasmuch as K. was in substance Y. Co., the agreement to vacate the premises entered into between H. and K. was binding on Y. Co.

(2) Development of the Doctrine

Undoubtedly this decision opened a Pandora's box. It
brought a remarkable increase in cases using the doctrine, most of which were rendered by the inferior courts to impose corporate debts on the principal shareholders or related companies. The Hoshihara decision set out two tests: i.e. the "shell" test and the "abuse" test. However, those tests are quite abstract and the current situation is still fluid.

The "abuse" test is often used when there is a company which has financially collapsed. The controllers of the company subsequently set up a new company to dump the business of the old company in it - the assets, goodwill, and employees. The shareholders and officers of the old company, often relatives, become those of the new company. The new company commences business activities which are virtually the same as those of the old company. The old company becomes empty without taking the formal proceedings for liquidation, or bankruptcy. If this scenario happens, the courts infer the intention of the controllers to defraud the creditors of the old company, and hold the new company liable for the debt of the old company on the ground that the corporate entity was abused to escape the debts and therefore it must be disregarded.22

Although there are anti-fraud provisions in Japanese law, to invoke them is often burdensome and is not so
effective. The doctrine therefore gives creditors a powerful weapon to attack evasive schemes of debtors.

As to the "shell" test, it is difficult to extract a fixed principle from the court cases. At any rate, the courts are liberal in applying the test to small one man companies. Experience indicates that the courts often consider the following factors: the company is completely controlled and managed by the principal shareholder who is also an officer; all other shareholders and officers are nominees of the principal; the business of the principal was converted to a corporate form for tax savings without changing the substance; the assets, account and business of the company are mingled with those of the principal; the corporate proceedings are neglected, e.g. directors' meetings, and the audit of financial statements. The courts use those factors to regard the company as a mere shell which is in substance a personal business, and hold the individual liable for the corporate debts.\(^{23}\) The misunderstanding of the other party or fraudulent intention of the principal is a plus factor, but not a \textit{sine qua non}.

The doctrine was used in situations which involved "thin capitalization" together with other factors of a "shell". In one case, the company had no assets from the outset, because the sole shareholder used the company to pay
off his personal debts. In another case, the sole shareholder used the company to acquire property and retained the property under his name while leaving the company liable for the debts. In both cases the creditors' claims against the principals were allowed by both the "shell" and "abuse" tests.

There are some cases in which creditors try to rely on the doctrine together with the provision concerning directors' liability to a third party mentioned before. Depending on the facts of each case, the courts allowed or dismissed one claim and/or the other. In one case the court held the directors liable to the third party for breach of duty of care, concurrently with holding the principal shareholder liable by disregarding the corporate entity.

(3) Is the Doctrine Overused?

Some commentators severely criticize the overuse of the doctrine, and strongly assert that an exhaustive analysis of the ordinary principles and provisions must be undertaken before jumping to this extraordinary doctrine.

For example, in one case the individual defendant (A.) who was dealing with the plaintiff (B.) incorporated a company
but failed to notify B. that the company would take over the business. Later, B. noticed the existence of the company from the company name painted on its truck and stamped on the cheques and promissory notes presented for payment. But B. thought A. was using the company simply for tax savings or some other purposes. The manner of the business was the same as before the incorporation. The company office was A.'s residence, and its telephone was that of A. He managed the business and the representative director, A.'s wife, was a nominal director. The court disregarded the corporate entity by the "shell" test and held A. liable to B. However, as discussed above, in Canada the courts treat this kind of situation as identification of the contracting party. Indeed, there is a Japanese court decision which held the representative director personally liable on the ground that he failed to discharge the onus to notify the other party that he was dealing with a company, without using the doctrine.

Further, Commercial Code art. 26(1) provides that the transferree of the business who subsequently uses the trade name of the transferor will be jointly liable for the debt which arose from the business of the transferor. Some of the abuse cases discussed above could have been settled by this provision. In fact, there are cases in which the debtor's evasive scheme to use a new company was successfully attacked by this provision.
While in Canada the courts rigidly stick to the principle of the separate entity and the resolution of resulting problems depends on legislative reform, the Japanese courts enthusiastically use the doctrine established by the case law, in spite of alternative statutory provisions which could be relied on.

FOOTNOTES (E. Lifting the Corporate Veil)

1 In the tax law area the courts are receptive to the doctrine. There is an extensive analysis in Dunford, "The Corporate Veil in Tax Law", 27 Can. Tax J. 282 (1979).

Another area in which the doctrine is often used is the circumvention of contract. The leading English case is Gilford Motor Co., Ltd. v. Horne, [1933] Ch. 935. A former employee who had covenanted not to solicit the plaintiff's customers incorporated a company. Under his control the company undertook soliciting. The company was held to be a mere "cloak or sham" for enabling him to commit a breach of the covenant, and the injunction was issued against both him and the company.

In Garbutt Business College Ltd. v. Henderson et al., [1939] 3 W.W.R. 257 (Alta. C.A.), the defendant, in breach of a covenant, commenced a competing business, and subsequently set up a company to continue the business. In holding both him and his company liable, the courts distinguished the cause of his liability (breach of contract) from that of the company (tort of inducement of breach).
Now the courts appear not so concerned about the nature of the liability of the company when they allow claims against it for its owner's breach of a covenant restricting competition: Greening Industries Ltd. et al. v. Penny et al. (1965), 53 D.L.R. (2d) 643 (N.S.C.C.); E.P. Chester Ltd. v. Mastorkis et al. (1968), 70 D.L.R. (2d) 133 (N.S.C.A.); Betz Laboratories Ltd. v. Klyn et al. (1969), 70 W.W.R. 304 (B.C.S.C.), varied on other grounds, 70 W.W.R. 742 (B.C.C.A.).

For other cases in which the corporate veil was lifted to attack the circumvention of contract, see Saskatchewan Economic Development Corp. v. Patterson-Boyd Manufacturing Corp. et al., [1981] 2 W.W.R. 40 (Sask. C.A.) (to avoid restrictions on shareholders' loans to the company, they set up a dummy company to make a loan); Big Bend Hotel Ltd. v. Security Mutual Casualty Company (1980), 19 B.C.L.R. 102 (B.C.S.C.) (a hotel owner incorporated a company to purchase fire insurance while concealing his previous fire loss). But see Metal Industries Association v. Butterfield Machinery Ltd. et al. (1982), 132 D.L.R. (3d) 490 (B.C.C.A.) (transfer of employees from one company to another company under the same proprietorship was found not for circumvention of obligation imposed on the former by an employers' association).

Further, the doctrine has been used in the case of breach of fiduciary duty of directors, officers, etc.: see Patton et al. v. Yukon Consolidated Gold Corporation et al., [1934] O.W.N. 321 (C.A.); Fern Brand Waxes Ltd. v. Pearl et al., [1972] 3 O.R. 829 (C.A.) (in both cases an officer attempted to make a secret profit by arranging a transaction between his company and another company controlled by him).

Among these cases, in the Canadian Aero, DCF Systems and W.J. Christie cases the courts held both the individual defendants and their new companies liable, without scrutinizing the nature of the liability of the latter. But in the Bendix Home case, the court refused the claim against the company noting that, inter alia, many other investors joined in the formation of the company, and the individual defendants did not control the company.

For other areas of law where the lifting the corporate veil becomes an issue, see Gower, Principles of Modern Company Law (4th Ed.) (1979), 112 - 138; Feltham, "Lifting the Corporate Veil", Special Lectures of the Law Society of Upper Canada (1968), 305.

2 In Japan, the number of court decisions in which the doctrine is used in other areas is relatively small. For example, there are only three cases which upheld the doctrine with respect to circumvention of contractual obligations: K.K. Kagami Chuo Uoichiba v. Tazaki et al., Kumamoto D.C. Yatsushiro Branch, January 13, 1960, 11 Kaminshu 4 (obiter); Yamamoto v. Goshi Gaisha Yakuruto Chita Eigyosho; Japan v. Yamamoto et al., Nagoya H.C. February 10, 1972, 25 Kominshu 48; Unknown v. Unknown, Omura Sm.C. September 25, 1972 694 Hanrei Jiho 109. In light of the purpose of this study, I omit an explanation of those other cases.


4 Clarkson Co. Ltd. v. Zhelka (1967), 64 D.L.R. (2d) 457 (Ont. H.C.). In this case, the bankrupt person manipulated his companies by transferring assets and money among them in a manner fraudulent to the creditors of the companies. However, the court held that it was not fraudulent to the bankrupt's personal creditors.

Of course, transfer of assets from the insolvent to his company can be fraudulent conveyance under the ordinary theory: Faulhaver v. Ulseth et al., [1976] 4 W.W.R. 48 (Alta. S.C.).


13. (1978), 5 B.C.L.R. 231 (Co. Ct.).

14. BCCA s. 314(i), old OBCA s. 231(2), new OBCA s. 229(2), CBCA s. 215(3)(4).


18. Bankruptcy Act ss. 3, 4(2), 78; for a more detailed discussion, see Honsberger, "Insolvency and the Corporate Veil in Canada", 15 C.B.R. (N.S.) 89 (1952); Houlden et al., Bankruptcy Law of Canada, current service (1979), Part 4, 125.


Kaminshu 797; Hanabusa v. Ueda Yoton K.K., Osaka H.C.
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25 Urata v. Hidaka, alias Yamazaki, Fukuoka H.C. July 22,
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26 K.K. Chohoku Shokai v. Koyanagi et al., Tokyo H.C. April
28, 1977, 357 Hanrei Times 278.

27 E.g. Egashira, Kaisha Hojin Kaku Hinin No Hori (Doctrine of
Disregard of Corporate Entity) (1980).

28 Yugen Gaisha Nakamura Komuten v. Ichige, Mito D.C. July 7,

29 Hoshino v. Nobuyuki Nagahara, alias Orion-Za, alias
Shin-Orion-Za, alias Arusaro-Orion, alias Nariyuki
Conclusion

In conclusion, I will quickly examine how the general propositions discussed in Chapter II are reflected in the foregoing five specific topics in the field of company law which have been examined here in detail.

(1) The Ultra Vires Doctrine:

This is an extreme example of the contrast between law reform by legislation in Canada and by case law in Japan. In Canada, although courts did gradually relaxed the standard of interpretation of object clauses, the reform of the common law principle of *ultra vires* was achieved by new company legislation. In Japan, the express provision in the Civil Code which codified the doctrine was gradually rendered meaningless by the changing case law. However, this topic also shows the problems of the Japanese approach. Firstly, the delay in the legislative reform is evident. The *ultra vires* provision in the Civil Code still remains the same, and the extensive 1981 amendments to the company laws did not touch it. In comparison, in Canada the old OBCA, which had reformed the common law position on this issue, was further reformed by the new OBCA. Secondly, the Japanese solution leaves a lot of ambiguity in the law. Although courts talk about the standard
of interpretation of objects clauses in abstract terms, its concrete application is not so clear. No attempt has been made to avoid uncertainty by skillful drafting of object clauses. Thirdly, there is a lack of any effort to create effective remedy provisions. The Commercial Code provision designed to challenge ultra vires acts has never been invoked. No effort has been made to make the provision more accessible and useful for aggrieved parties. This contrasts with the position in Canada. These factors highlight the very different responses to a similar problem which have emerged in Canada and Japan.

(2) Pre-Incorporation Transactions:

In Canada, the strict common law principles concerning pre-incorporation transactions ultimately were reformed by legislation. In Japan, statutory provisions imposing strict controls on pre-incorporation transactions forced the courts to take a strict position. However, the courts exercised some degree of flexibility in offering remedies to parties dealing with promoters. This example also shows the problems of the Japanese approach. Firstly, the delay in legislative reform is again seen here. The inconvenience to commercial parties comes from the fact that the controls on pre-incorporation transactions in the Commercial Code neglect the security of transactions. But no legislative solution has been forthcoming
to improve the situation. Secondly, there is ambiguity in the Japanese solution. The remedies of unjust enrichment or liability of an unauthorized agent are themselves of uncertain nature. It is unclear whether the succession theory adopted by some inferior courts will be accepted by the Supreme Court. Thirdly, in Canada, the old and new OBCA and the CBCA give the court a discretionary power to apportion liability between a promoter and the new company. There is a little possibility that such a radical remedy will be created in the Japanese company legislation and it is unlikely that a court could reach this result by itself. Accordingly, the extent of reform in Japan tends to be more limited than in Canada.

(3) A Director's Transaction with His Company:

Here, again, the common law principles were replaced by detailed statutory provisions in Canada. In contrast, the equivalent provisions in the Commercial Code in Japan are rather simple, and case law has created the substance of the law. As to the scope of transactions which require the board of directors' approval, the courts created exceptions on the one hand, and expanded the scope of transactions on the other hand. Further, courts have created a new rule concerning the validity of transactions which lack the requisite approval. Changes in precedents on these issues are an important factor
in the development of law. However, the problems in the Japanese approach are also clear. Legislative reform is extremely slow. The 1981 amendment simply codified the case law concerning the scope of regulated transactions, and added the ex post facto reporting requirement. With respect to the validity of transactions which lack the directors' approval, legislators left the solution to case law. With respect to the application of the liability provisions, there is a confusion among commentators, and the lack of case law leaves the issue in an ambiguous state. Legislators did not make the situation clear either. The lack of case law can be attributed to the difficulties in bringing a derivative action against directors. So far, no legislative reform has been made to reduce such difficulties.

(4) The Director's Duty of Care, Diligence and Skill:

In Canada, legislative reform aimed at upgrading the common law standard of the director's duty of care, diligence and skill has been unsuccessful. Instead, specific liability provisions to condemn the improper conduct of directors have been extended in the new company legislation and the new bankruptcy legislation. In Japan, the development of law in this area has been achieved by case law. While the statutory provision concerning the standard of the duty of care remains
abstract, courts have built up a strict standard. Courts have used techniques such as the reading of the duty to monitor the execution of corporate affairs into the duty of care, and the application of the provision concerning a false registration by analogy. However, problems exist in this area, too. Directors who are held liable for the breach of duty of care are normally those of small companies. Controls on their conduct in the current company legislation are not sufficient, and legislative reform in this regard is delayed. There is a confusion among inferior courts with respect to whether a subjective, lower standard of care should be used for nominee directors. The Supreme Court did not make this clear, although an appropriate case did come before it. Legislators have not solved the ambiguity either, as they have chosen to leave the matter to case law. So we see a lack of legislative will to act in a very significant area of law in Japan, unlike in Canada.

(5) Lifting the Corporate Veil:

In Canada, the imposition of personal liability on controllers of a company depends on the creation of specific liability provisions, as the principle of the *Salomon* case is still dominating the Canadian Case law on this issue. In Japan, courts enthusiastically use the doctrine of disregard of the corporate entity which was imported from the U.S. for that
purpose. This example also shows problems of the Japanese approach to law reform. The typical company which becomes the target of the doctrine is a small, closely-held company or a so-called one man company. A number of such companies are incorporated as a stock company. But they often neglect the formalities required by law, and cause many problems. There is a notable delay in the reform of company law in Japan to control these small companies. Similarly, there is a delay in solving many problems in the existing laws concerning remedies of creditors of insolvent companies. Such delay lies behind the frequent use of this extraordinary doctrine. Further, the criteria of the doctrine are not so clear. While courts rely on the two broad criteria set out by the Supreme Court, they do not attempt to make the criteria more specific.

The foregoing five topics amply demonstrate the characteristics of the Japanese case law. Through creative interpretative techniques and changes in precedents, the courts create the substantial portions of law, and even reform the statute law. However, they also show problems of the Japanese approach. The most notable one is a lack of law reform, as compared with the legislative reform of Canadian company law. For example, a lack of adequate control on small stock companies has created a monstrous situation. Now that the 1981 amendments have been finished, this issue has finally become
the agenda of the next company law revision. In contrast, in Canada there are independent legislative commissions which check up on all relevant issues and propose radical reform of the law. One jurisdiction can learn from the experiments in the others. As mentioned in Chapter II, there are various difficulties in legislative reform in Japan. However, it should be noted that the Japanese company legislation has been in fact amended partially from time to time, as summarized in Chapter II. There even have been occasions in which intolerable results of court decisions were overturned by legislative reform. Therefore, as a matter of theory, it could be possible to design exhaustive statutory provisions to replace case law principles, despite the difficulties I have explored. Nevertheless, many other important or complex legal issues are still left to case law, not just the foregoing five topics. It seems to reflect not only a recognition of the role of case law in the development of law, but also an inclination among Japanese people towards ambiguity in the law, or a relative lack of willingness to make the existing law more certain.

I would reiterate that this study is by no means an exhaustive analysis of the Japanese law. The five topics in only one area of law are obviously insufficient for that purpose. There are many other legal issues in which case law
and statute law make for complex relations. Also, there are other factors which should be carefully studied, e.g. the role of scholarly arguments in the development of case law on each legal issue. I hope this study will be taken as an introduction to the reality of case law in Japan and will facilitate further studies by foreigners.

FOOTNOTE (Conclusion)

1. The process of the recent legislative reform of Canadian company law and the work of law reform commissions are well summarized in Iacobucci et al, *Canadian Business Corporations* (1977), 1 - 5.
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