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The Close Corporation in Japanese Law

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I. Introduction

As in many countries, regulation of close corporation activities is a major issue in Japan. The number of close corporations in our country exceeds that of many other countries, such as the Federal Republic of Germany and the United States of America, and close corporations are presently governed by the same laws which were designed to provide for the needs of large or publicly held enterprises. Therefore, close corporations give rise to serious legal problems.

The purpose of this paper is to serve as an introductory source for comparative treatment, to point out the legal problems that are encountered by Japanese close corporations, and to describe how such problems are handled by the courts and the legislature. The paper begins with a survey of Japanese law relating to business organizations and presents reasons for the existence of so many close corporations. The paper then examines the special treatment given close corporations from both the judicial and the legislative points of view. Finally, the paper briefly attempts to formulate general guidelines for new legislation designed to meet the needs and realities of the Japanese close corporation.

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II. Background of Close Corporation Problems

1. The Types of Law

Following the example of the German legal system, there are four kinds of business associations in Japan. They are the "*gōmei* company" (in German called *offene Handelsgesellschaft*), the "*gōshi* company" (in German called *Kommanditgesellschaft*), the "corporation" (*kabushiki kaisha*), and the "limited liability company" (*yūgen kaisha*). The limited liability company is mainly regulated by the Limited Liability Company Law adopted on April 5, 1938, and other three associations are mainly regulated by the Commercial Code adopted on March 9, 1899. In Japan all of these associations are treated as separate legal entities.

The liability of the members is the main criterion distinguishing these types of associations. In the *gōmei* company, as in the United States partnership, each member is personally liable for all debts of the company. Because of this unlimited personal liability, it is important that each member has control over the identity of his associates. A mandatory provision requires therefore the consent of all other members for a transfer of any member's share (*mochibun*), which represents his right in the company. Moreover, each member, on principle, has the power to manage the business of the company, and unanimous consent of the members is required for basic changes, like an alteration of the articles of association. Thus, the *gōmei* company is known as a personal association in which emphasis is laid on the personality of the members. Therefore, this type of association is well suited to family businesses or small traders who wish to combine in business with their relatives or friends.

The *gōshi* company is a company which is constituted by members who are liable for all debts of the company and by members whose liability is limited to the amount of money they have invested in the company. The members with limited liability have no power to manage the business of the company. The other regulations relat-

ing to the *gōshi* company are, for the most part, the same as for the *gōmei* company, and the *gōshi* company is therefore quite similar to the United States limited partnership. Like the *gōmei* company, the *gōshi* company is known as a personal association. Therefore, this type of association is also suited to family businesses or small traders.

In the corporation and the limited liability company, each member is liable only for the amount of money he has invested in the association. In these types of associations, therefore, emphasis is laid on the importance of money. They are known as capital associations.

As in many countries, the Japanese laws relating to the corporation were designed for large or publicly held enterprises. Consequently, methods of incorporation, management and finance are formalized, and the legal rules are, for the most part, mandatory.

For incorporation there must be seven or more incorporators. The incorporation procedure is complicated, mainly for the protection of third parties who transact business with the corporation. The court and a judicially appointed inspector carefully examine the correctness of the incorporation procedure. The shares (*kabushiki*) of the corporation are negotiable instruments, and to facilitate their free circulation among the public, they are, on principle, freely transferable. There is a tripartite management system, *viz.*, the general meeting of shareholders, the board of directors and the representative directors, and the statutory auditor. The general meeting was in theory all powerful, but since 1950 it no longer has general authority but is limited to the exercise of such specific authority as is set forth in the statute and the articles of association. The general meeting is an expensive formality. Each corporation must have three or more directors, and since 1950 the board of directors, following the Anglo-American management system,[1)]

1) The management system of the corporation was reformed in 1950 to introduce Anglo-American approach. This reform has been documented in T. L. Blakemore & M. Yazawa, *Japanese Commercial Code Revisions*, 2 AM. J. COMP. L. 16 (1953).

has had authority over policy decisions; however, some directors appointed by the board possess the authority to represent the corporation. The statutory auditor had only power to audit and examine financial statements. However, as is mentioned in next section, the audit system now varies with the size of the corporation. Corporate accounting procedures are complicated, and the balance sheet must be published in the official gazette or the daily newspaper.

Following the German *"Gesellschaft mit beschränkter Haftung"*,[2] the limited liability company was introduced by comprehensive legislative enactment as a simpler form of legal entity with limited liability. It need not have the complicated apparatus nor follow the formalized and stringent rules of the corporation, and thus it can function in a simpler way. In addition, the Japanese limited liability company emphasizes the closeness of a company.

The founding procedure of the limited liability company is uncomplicated. Unlike the case of the corporation, there is no examination of the procedure. However, a minimum capital of 100,000 yen (that is a value of a typewriter!) is required, and a one-man company is not permissible. The number of members should be, on principle, not more than fifty. In the limited liability company, to make the members' shares negotiable is prohibited, and to prevent the intrusion of strangers, a mandatory provision requires the approval of the members' meeting for a transfer of shares to persons other than members. Unlike the corporation, the management system is uncomplicated and flexible. Unless otherwise provided in

2) The German limited liability company (GmbH) and its governing statute have been given intensive treatment in American publications. See D. Schneider, *The American Close Corporation and Its German Equivalent*, 14 BUS. LAW. 228 (1958); H. Vries & F. Junger, *Limited Liability Contract: The GmbH*, 64 COLUM. L. REV. 866 (1964). The German statute concerning the limited liability company was partially reformed in July, 1980. For the amendments, see K. Deutler, *Änderungen des GmbH-Gesetzes und anderer Handelsrechtlicher Vorschriften durch die GmbH-Novelle 1980*, GmbH-Rdsch. 145 (July, 1980).

the statute, the members' meeting is all powerful, and the members can make special provision in the articles of association concerning members' voting rights and qualification of directors. In passing resolutions, the consent of all members can dispense with notice of meeting. Moreover, the consent of all members in writing to a specific resolution, or the prior agreement to be bound by a written vote, makes a formal meeting unnecessary. There must be one or more directors but the system of board of directors is not required, and each director has the power to manage the business of the company. Each director also possesses, on principle, the authority to represent the company. The statutory auditor is optional and has only power to audit and examine financial statements. The limited liability company is prohibited from issuing bonds. When additional shares are issued, public offerings are prohibited. Unlike the corporation, the balance sheet need not be published. Thus, the limited liability company is well suited to the purpose of small or closely held enterprises, by combining the benefit of limited liability with the characteristics of personal associations.

2. Business Conditions Giving Rise to Close Corporations

The corporation enables businessmen to limit their liability to the amount invested in the shares held by them. In view of this evident advantage, many corporations have been formed, especially in the period following World War II. Since the introduction of the limited liability company, it has become possible to attain the same economic object without incorporation. However, contrary to the aim of the promoters of the statute, the corporate form remains very popular not only with large enterprises but also with small business people, and the limited liability company has not superseded the corporation as a form of small business organization in Japan[3];

3) In the Federal Republic of Germany, the small corporation is eliminated by the requirement of a minimum capital of 100,000 DM, and the limited liability company (GmbH) enjoys great popularity in small business. Cf. Aktiengesetz (Corporation Statute), law of June 9, 1965, art. 7.

many small corporations are in existence, and it is significant in this connection that the shares of most Japanese corporations are not quoted on the stock exchange.

Statistics on the number of corporations in existence on December 31, 1979 are as follows:

Amount of Capital (unit million yen)	Number (total 940,662)
under 1	66,364 (7.1%)
under 10	739,516 (78.6%)
under 50	923,379 (98.2%)
under 100	930,373 (98.9%)

Small business people choose the corporate form for several reasons: First, the corporation is often advantageous from a taxation standpoint, although its advantage here is the same as for other business associations. Second, the statute contains no provisions requiring a minimum capital for the corporation. Consequently, seven persons of slender financial resources may validly form one. Third, the word "corporation" is more advantageous than "limited liability company", especially in trading with customers and in borrowing money from the bank. In Japan, this third reason is strong. Fourth, because some provisions relating to the corporation are applied correspondingly to the limited liability company, it is difficult for small business people to understand the company laws. Fifth, in practice it is so easy to avoid the regulations of the corporation statute that small business people may constitute and manage the corporation much as they would a limited liability company.

When small business people choose the corporate form, serious legal problems can arise. In many small corporations, the total invested capital is small, and there are relatively few shareholders, who are often active in the business, in many cases deriving their livelihoods from the earnings of the corporation. Moreover, in such corporations not only is there no public market for its shares, in fact free transferability of its shares is often undesirable, because the

shareholders wish to keep their ranks closed and to exclude the admission of strangers. From these specific characteristics, this type of corporation might be described as the counterpart of the "American close corporation".

Publicly held corporations and close corporations are, therefore, utterly different in their nature and in their methods of operation. However, many close corporations are presently governed by laws which were designed to provide for the dissimilar needs of publicly held ones. Few close corporations, therefore, adhere to the formalized and stringent rules of the corporation.[4] For instance, the capital of the corporation, which the shareholders have undertaken to contribute, is often, in fact, not paid. Sometimes share certificates are not issued. Shareholders and directors meetings are not held and other corporate rituals are disregarded. The balance sheet is not published. Consequently, the laws relating to the corporation function poorly at best for close corporations and they also give rise to litigation over various parties' rights when the legal rules are not observed, so Japanese courts are compelled to settle many such disputes.

III. Approaches toward Solving the Problems

1. Pleas for Special Legislation

During the past twenty years, many Japanese scholars and lawyers in the field of commercial law have deplored the abuse of the corporate form by many small business people. To rectify this situation, they have pointed out that the legal rules should be more flexibly applied in the case of close corporations and have suggested that legislation designed to meet the needs and realities of close

4) The recent investigation into the state of operation of the corporation law in close corporations is summarized in the report of Shōhōkaisei Kenkyūkai, *Kaishahō Unyō no Jittai to sono Bunseki—Hikōkai Kaisha* (State of Operation of Company Laws and Its Analysis: Closely Held Company), No. 606 SHŌJI HŌMU 6 (1972).

corporations should be instituted. Although most of these assertions were made in general terms, in recent years some writers have examined the relevance of American, English and German experience concerning separate judicial and statutory treatments for close corporations, and some have attempted to formulate concrete legislation to fit the characteristics which obviously distinguish close corporations from publicly held ones.[5)]

2. Special Judicial Treatment of Close Corporations

In the meantime, Japanese courts have gradually recognized the special problems of the close corporation.

As to problems concerning internal matters, the decision of the Supreme Court rendered on June 24, 1971 held that in a one-man company an action by the shareholder without a prior notice and without a meeting is nevertheless as valid as a shareholder's action. No transfer of the shares before issuance of share certificates is enforceable against a corporation under article 204(2) of the Commercial Code; however, the decision of the Supreme Court rendered on November 8, 1972 held that a close corporation which has not issued share certificates for a long time cannot refuse the transfer. Under article 265 of the Code the consent of the board of directors is required for transactions between a corporation and its director or a third party for whom he acts. Therefore, litigation often arises to invalidate such transactions in close corporations in which a directors meeting is not held. However, the decision of the Supreme Court rendered on August 20, 1970 held that a transaction between the director and a one-man company of that director is not invalid because there is no conflict of interest between them. Subsequently, the decision of the Supreme Court rendered on September 26, 1974

5) See T. Sakamaki, Heisateki Kaisha no Hōri to Rippō (Legal Principles and the Legislation for the Closely Held Corporation), Nippon Hyōron Press (1973); M. Hamada, Amerika Heisa Kaishahō (American Close Corporation Law), Shōji Hōmu Kenkyūkai Press (1974); S. Aotake, Shōkibo Heisa Kaisha no Hōkisei (Regulations for the Small and Close Corporation), Bunshindō Press (1979).

held that consent to a transaction by the board of directors can be superseded by unanimous agreement of the shareholders.[6]

As to problems concerning third parties, the decision of Supreme Court rendered on February 27, 1969, which was the first Supreme Court case applying the doctrine of "piercing the corporate veil" in Japan, held that the corporate entity may be disregarded, (1) when there is intentional perversion of the corporate personality or (2) when the corporation is the mere adjunct or alter ego of a shareholder. The "perversion" doctrine seems to be derived from old American case law or German law, and the "alter ego" doctrine is similar to "instrumentality rule" which is now influential in the U.S.A..[7] According to this Supreme Court decision, many courts have allowed to disregard the corporate entity under such circumstances.

Article 266-3 of the Code provides that the director is liable in damages to third parties if he is guilty of wrongful intent or gross negligence in the exercise of his duties, or if he has made a false statement, or concurred in the inclusion of a false statement, in the accounts of the corporation. Although the meaning of this provision has been a subject of debate, many courts including the Supreme Court recently have interpreted it to mean that negligent exercise of director's duties "to the corporation" is sufficient for liability. That interpretation is intended to protect third parties who have entered into transactions with close corporations of slender financial resources. Consequently, article 266-3 carries out the same function as the doctrine of piercing the corporate veil. Furthermore, recent decisions have applied this provision to dummy directors, who often exist in close corporations because of the requirement of a minimum

6) For decisions above mentioned, see Aotake, *supra* note 5, at 367 et seq.

7) For Japanese "piercing" cases in comparison with American and German law, see K. Egashira, Kaisha Hōjinkaku Hinin no Hōri (Legal Principles of Piercing the Veil of Corporate Entity), Tōkyō Univ. Press (1980).

number of three under article 255 of the Code. The decisions indicate that even though such a director is intended as a mere figurehead who actually performs none of the duties of the position, he nevertheless owes a duty to supervise the activities of other directors. They also indicate that while he may have accepted his position as an "accommodation" to the corporation with the advance understanding that he would perform no duties, he is not relieved of his responsibility to third parties. Thus, dummy directors may not now assert ignorance as an excuse for nonfeasance, and the habitual failure to attend directors meetings and to pay attention to the corporation's affairs itself constitutes negligence.[8]

3. Statutory Provisions Enacted and Proposed for Close Corporations

On the other hand, the National Diet gave its approval to legislation directed toward the problems of the close corporation.

The partial revision of the Commercial Code in 1966, in article 204(1), allowed placing restrictions on the transfer of shares. This provision authorizes the corporate articles of association to include a clause requiring the consent of the board of directors for the transfer of any shares. The clause may be inserted in the original articles of association or may be added later by amendment. Thus, the close corporation shareholders who wish to close their ranks against the admission of strangers may achieve their aim in some measure by inserting such clause into the articles.

The revision of the corporate auditing system in 1974[9] drew a clear distinction between large, medium and small corporations for

8) For decisions above mentioned, see Aotake, *supra* note 5, at 411 et seq.; Aotake, *Saikin no Hanrei ni miru Meimokuteki Torishimariyaku no Daisansha Sekinin* (Responsibility of Dummy Directors to Third Parties in Recent Cases), 82 MINSHŌHŌ ZASSHI (No. 3) 309 (1980).

9) The 1974 amendaments have been outlined in M. Smith, *The 1974 Revision of the Commercial Code and Related Legislation*, 7 LAW IN JAPAN: AN ANNUAL 113 (1974).

auditing purposes. The role of the statutory auditor in large corporations, whose paid-in-capital fund is over 500 million yen, and medium corporations, whose paid-in-capital fund falls within the range 100 million to 500 million yen, has been modified to confer a wide duty to audit not only the accounts of the corporation but also the director's exercise of their functions. Accordingly, wider powers have also been conferred. A new position, the accountant auditor, has been created in large corporations. The accountant auditor's primary responsibility is to audit the accounts, and the position must be filled by a qualified public accountant or an audit association. However, the auditing system for small corporations whose paid-in-capital fund is less than 100 million yen continues much as before; in other words, the statutory auditor has limited authority and the accountant auditor is unnecessary.

Since the partial revisions are insufficient to solve the problems of the close corporation, a fundamental reform of the laws relating to the corporation and the limited liability company has been proposed. At the time of the revision of the corporate auditing system, the Judicial Affairs Committee of the House of Representatives adopted, on July 3, 1973, a resolution urging the Administration to study at the earliest date possible "the advisability of amending the existing provisions relating to social responsibility of the corporation, the role of the general meeting of shareholders, the structure of the board of directors, the value of each share, and whether to institute provisions designed to make a distinction between large and small corporations in the application of the statutory corporate system." This was followed by another resolution, adopted by the Judicial Committee of the House of Councillors on March 19, 1974, which stated "in view of the present situation relating to corporate practices, the Administration should promptly draw up, for introduction before the Diet, a bill designed to simplify and rationalize the business operation of small corporations by instituting a separate system for them, to ensure the fair and equitable business operation of large corporations, to strengthen the

protection of the shareholders, employees and creditors, and at the same time to encourage corporations to fulfill their social responsibility by reforming the general meeting and the system governing the board of directions."

Pursuant to these resolutions, the Panel on the Commercial Code of the Legislative Council, an advisory body to the Minister of Justice, began in September, 1974 a review of the basic problems involved in the existing corporate laws. In order to review from as broad a perspective as possible, the Panel distributed an extensive enquete to the legal and the commercial community in Japan.

An enquete entitled "Issues Relating to Corporate Law Reform", which was published on June 12, 1975 under the name of the Councillor's Office of the Ministry of Justice's Civil Affairs Bureau, raised in its final part[10] the question of "The Minimum Capital System and the Division of Corporations into Two Categories: Small and Large".

It raised the following questions:

(1) In view of the actual operation of the corporation system in our country:

(i) Do you feel that a minimum capital system should be established?

(ii) Assuming that a minimum capital system is established in our country:

(a) Some people argue that the minimum capital requirement should be at least 50 million yen. What do you think is an appropriate amount?

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10) Other questions listed in the enquete were the following: 1. Social Responsibility of Enterprises 2. Reform of the System of the Shareholders General Meeting 3. Reform of Provisions relating to Directors and the Board of Directors 4. Reforming the Stock System 5. Corporate Accounting and Public Disclosure 6. Conglomerates, Mergers and Partion of Enterprises. These questions have been translated into English in Comment, *Commercial Law Reform in Japan: The Current Debate,* 11 LAW IN JAPAN: AN ANNUAL 102 (1978).

(b) How do you propose that existing corporations, whose capital falls short of this minimum requirement, should be treated? In this connection, some people suggest that these corporations should be allowed to increase their capital during a certain grace period or else restructure themselves into a limited liability company. Do you agree with this suggestion?

(2) In view of the scale of the corporations in our country and their actual operations:

(i) Some people argue that in order to ensure the fair and equitable business operation of large corporations and to simplify the operations of small corporations, different regulations should be devised according to the size of the corporation. What do you think of this suggestion?

(ii) If different regulations were devised, according to the size of the corporation, the following items have been considered as criteria for classifying corporations into different categories: the capital or the amount of total assets, the number of shareholders, and the type of ownership (whether a corporation is publicly held or privately owned, or whether or not it allows transfer of its shares). What do you believe are the proper criteria for classifying corporations for the purposes of regulation? Some people argue, for instance, that a corporation whose total number of shareholders is within the limits imposed on the number of members of a limited liability company, and which restricts the transfer of its shares, should be allowed to operate its business in a manner similar to that of a limited liability company. How would you approach this problem?

(3) In addition to the suggestion outlined in (1) (i) and (ii) above, some people maintain that the minimum capital requirement of the limited liability company should be

raised (say to 5 million yen). What is your opinion? Do you feel that there are other provisions in the Limited Liability Company Law that should be improved?

The enquete received much comment. There was much scholarly argument about it. In the comment or argument,[11] there are many affirmative views on the questions of establishing a minimum capital system and devising different regulations according to the size of the corporation. However, as to an appropriate amount of the minimum capital, they vary from 1,000 million to 50 million yen, and as to criteria for classifying corporations, they also vary as listed in the enquete. Further, there are various opinions with respect to the form of legislation in order to simplify the operation of small or close corporations; that is, whether regulations applying to the small or close corporation should be partially scattered throughout the Commercial Code or should be separately grouped within it, and there exists the opinion that the close corporation should be regulated by the Limited Liability Company Law revised.

By reference to these comments or opinions, the Panel began in 1976 a review of corporate law reform, and a tentative draft relating to the reform of the stock system, the management system, and corporate accounting and public disclosure is now published. However, reform meeting the problems of the close corporation has not yet been forthcoming.

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11) For these, see Kitazawa, Shimizu, Hoshino and Yazawa, *Zadankai: Kaishahō no Konponteki Kaisei no Mondaiten* (Round Table Discussion: Issues in the Fundamental Reform of the Corporate Laws), No. 593 JURISUTO 14, 36 et seq. (1975); Yazawa, Kawamoto, Shimizu and Takeuchi, *Zadankai: Kaishahō Kaisei ni kansuru Mondaiten no Kenkyū—Saitei Shihonkin Daishō Kaisha no Kubun* (Round Table Discussion: Studies on Issues in the Reform of the Corporate Laws—Minimum Capital System and the Division of Corporations into Two Categories: Small and Large), No. 710 SHŌJI HŌMU 10 (1975); I. Inaba, *Kaishahō no Kaisei ni kansuru Kakukai no Iken ni Tsuite* (Views of Various Circles on the Reform of the Corporate Laws), No. 616 JURISUTO 21, 32 et seq. (1976).

IV. Conclusion

As mentioned above, like the U.S.A., it is so necessary to provide a functional and legally enforceable basis for operating as a close corporation that realization of fundamental reform of the existing corporate laws is desirable at the earliest date. Accordingly, it is necessary to formulate a concrete provisions for the close corporation. The writer's opinions against the enquete above mentioned are as follows.[12)]

Although a minimum capital system should be established, it is undesirable that small business be prohibited from using the corporate form by a requirement for a large amount of capital. As criteria for classifying corporations into different categories, closeness of the corporation is more appropriate in regard to the need for different methods of operation in such corporation. It will be proper to define the close corporation as one whose shares are restricted on transfer and whose shares are not generally traded in the securities markets. As the form of legislation for such close corporations, it may be appropriate that the regulations applying to them be clearly differentiated in the Commercial Code as a separate group, in view of the existence of many close corporations and the benefits associated with the word "corporation", even though there exist some opinions that the close corporation should be regulated by the Limited Liability Company Law revised.

It is more important what kinds of statutory provisions should be laid down for the close corporation. Unlike the U.S.A., through lack of recognition, few have argued that such provisions are necessary as to liberate close corporation planning, to confront the need to minimize unfairness and oppression of minority shareholders,

12) For detail of the writer's opinion, see Aotake, *supra* note 5; Aotake, *Amerika Kaishahō ni Okeru Saikin no Dōkō—Heisa Kaisha* (Recent Trends in American Corporation Law: the Close Corporation), AMERIKA HŌ 1 (November, 1980).

and to resolve serious disputes and deadlocks among shareholders. However, close corporation legislation should give flexibility in some measure by permitting control of internal matters by appropriate provision in the articles of association. Further, although articles 408-3 and 245-2 of the Commercial Code, which followed the American law, confer appraisal rights on dissenters in cases of consolidation, merger, and sale of all or a large part of the corporate assets, in the close corporation the circumstances entitling a minority shareholder to demand that the corporation purchase his shares should be broadened. And, although article 406-2 of the Code entitles a minority shareholder to sue for dissolution of a corporation, the circumstances forming the basis for a dissolution demand are strictly limited, so in the close corporation the importance of the right should be recognized and that provision should be revised.

As to simplification of the management system and procedures of the close corporation, like the limited liability company, requirement of a minimum number of directors should be dispensed with, and the system of board of directors and statutory auditor should be optional.

It is hoped that this paper will serve as a useful source for a more comparative treatment.