THE RELATIONSHIP BETWEEN THE COMMERCIAL REGISTRATION SYSTEM AND PROVISIONS THAT PROTECT RELIANCE ON EXTERNAL APPEARANCES IN JAPAN

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Japanese law requires that certain matters concerning corporations be entered in the Commercial Register. One of these items of information is the name of the company's representative director. Similarly, the resignation of this person, or the lapse of his authority to represent the company must also be registered. At the same time, however, the law permits a third party who is unaware of the registered information to rely on the mere external appearance of representative authority. These two threads have given rise to numerous liability problems. In 1974 the Japanese Supreme Court addressed these, but in turn, created new controversies. This article will study the court's analysis and resultant controversy, examine interpretations set forth by respected scholars, and present a new interpretation of the law. The focus throughout will be on how best to resolve the troublesome liability questions.

I. Decision of the Japanese Supreme Court

The liability issue arose out of the following fact situation [1]. A representative director A of defendant corporation Y was made to resign and the resignation was entered in the Commercial Register. At some time later, A drew a promissory note as representative director of Y on B. B in turn transferred the note to plaintiff X. X brought action against Y to demand payment on the note.

The Court of Appeals found for X. The Supreme Court, however, found differently:

Since resignation of a representative director of a stock corporation and lapse of authority to represent the corporation are matters that must be registered pursuant to articles 188 and 15 of the Commercial Code ..., only article 12 of the Code should be applied to resolve this case. Therefore, subsequent to registration, the facts of the resignation and the lapse of authority can be invoked

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against a third party who did not know of these facts, provided that there was not a reasonable cause for his ignorance of the registered facts. It should be understood that Civil Code article 112 is not applicable to this case.

Reversing the Court of Appeals, the Supreme Court instructed the trial court to try the issue of reasonable cause.

2. Constructive notice theory

Commercial Code, article 12, provides:

Matters required to be registered cannot be set up against a bona fide third person until the registration and public notice thereof will have been duly effected; even after the registration and public notice of such matters will have been effected, they cannot be set up against a third person who for any reasonable cause has been unaware of them [2].

The prevailing scholarly interpretation of the article rests upon the so-called constructive notice theory [3], which presumes that a third person has notice of registered information. One of the most celebrated textbooks on the subject maintains that the “commercial registration system serves as a means to publicize certain important information and regulate conflicts between merchants and third persons by deeming a third person to have notice of publicly registered matters and by no longer allowing a third person to plead ignorance of such matters” [4]. Furthermore, the constructive notice theory construes the phrase “any reasonable cause” very narrowly to mean objective obstacles encountered by a third person when he investigates the commercial register, e.g. interference with the mails or traffic, or loss of or stain on the Commercial Register entry itself.

The Supreme Court decision is perfectly consistent with this theoretical framework. Civil Code article 112 maintains that “lapse of the power of representation cannot be set up against a bona fide third person, unless such third person was unaware of such fact through negligence” [5] thus requiring proof of the third person’s ignorance of the lapse of representative authority. If Commercial Code article 12 presumes knowledge of the lapse of authority as the constructive notice theory understands, Civil Code article 112 cannot be applicable as long as Commercial Code 12 covers the situation.

The practical result of the court’s decision is not desirable, however. In order to safeguard his self-interest, a third party will need to investigate the Commercial Register every time he enters into a commercial transaction with a merchant. Thus, he will no longer be able to rely on the fact that a particular person was recently elected to be a representative director of the corporation because that person may have resigned and that fact may have been entered in the Commercial Register. This imposes an excessive burden on the third person.
and unnecessarily threatens the security and efficiency of the underlying transactions. The question then arises: Is the court’s decision desirable? Does it appropriately address the potential conflicts of interest between the merchant and the third person?

Most scholars who have commented on the decision have questioned the appropriateness of its result and have formulated their own interpretations of the law designed to protect the bona fide third person. The most widely supported of these formulations relies on an expansive interpretation of article 262 of the Commercial Code, which states:

A company shall be liable to a bona fide third person for any act done by a director invested with any title such as president, vice-president, chief director or managing director from which it may be assumed that he has authority to represent the company even in cases where such person has no power of representation [emphasis added] [6].

In this formulation, the phrase “invested with any title” is construed broadly to encompass the situation in which the company was aware of the unauthorized use of the title but did not complain about it. Had the Supreme Court used this formulation, it might have found in favor of the third party, X [7].

In any case, while courts and scholars agree that article 262 is applicable notwithstanding article 12, they place themselves in an analytic bind. Since their constructive notice interpretation of article 12 assumes that a person who is able to investigate the Commercial Register has notice of what is in it, there is no room for application of article 262, which requires proof that the person was ignorant of the information. Article 262 was enacted into law in 1938, when article 12 was already on the books. Scholars maintain that the former supersedes the latter and they base this opinion on either of the following two theories: (1) article 262 is an exception to article 12 [8], or (2) reliance on external appearance of authority constitutes a “reasonable cause” under article 12 [9]. Neither theory is entirely satisfactory.

With respect to the first, or so-called exception theory, the question arises: Since both articles 262 and 112 are intended to protect reliance on the external appearance of authority, why is not article 112 also considered an exception to article 12 [10]? Even more troublesome is the fact that if the exception theory does extend to article 112, and subsequently to every other provision that protects the reliance on external appearances, the question arises: What is the purpose for having article 12 at all?

With respect to the second, or so-called external appearance theory, the question arises: Why does not article 112 also fall within the “any reasonable cause” defense of article 12? Moreover, it is difficult to justify the interpretation that the whole of article 262 falls within the subjective “reasonable cause” requirement of article 12 because article 262 contains both an objective and a subjective element. Objectively, the provision allows the third person to assume there is appropriate authority in a director who has a title from which it may
be assumed appropriate authority exists; subjectively, it requires that the third person was unaware of the lack of representative authority.

3. Critical analysis of the constructive notice theory

The confusion engendered by the Supreme Court decision is mainly the result of the constructive notice interpretation of the first sentence of Commercial Code, article 12, which indicates that information required to be registered cannot be invoked against a third person until it has been registered and made public; the implication, of course, is that the information may be invoked after it has been registered. The constructive notice theory’s conclusion that a third person is deemed to have notice of registered information does not, however, follow directly from this sentence. In order to validate such a deduction the sentence’s prescriptions would have to be divided into two propositions: first, that information required to be registered cannot be invoked against a third person who was ignorant of it, whether it was registered or not; and secondly, that a third party is deemed to have notice of the information after it has been entered in the Commercial Register. If article 12 really only means to say the second proposition (hereinafter referred to as proposition II) then it must be presupposed that the first proposition (hereinafter referred to as proposition I) is so obvious that nothing explicit need be said about it.

Even if proposition I is a natural principle, explanation must be given with respect to proposition II for why the third person should be deemed to have notice of registered information. The constructive notice theory explains this by imposing upon the third party an absolute duty to investigate the Commercial Register [11] whenever he enters into any transaction with a merchant. If, in fact, he fulfills this obligation to investigate the Register, he will not be ignorant of the registered information, and therefore cannot plead ignorance of the registered fact.

Nonetheless, even if proposition I is accepted, the imposition of an absolute duty of investigation on the part of the third person is not the only logical result of the prescriptions of article 12. The second sentence of the article indicates that even after information has been registered, it cannot be invoked against a third person who, for “any reasonable cause”, was ignorant of it. In order to be consistent with the constructive notice theory, it is more precise to say that one would be deemed to have notice of registered information only if he did not have a “reasonable cause” for his ignorance. Furthermore, the theory requires, in order to justify holding the third person responsible for knowing what is contained in the Register, absent “any reasonable cause”, there must be imposed a duty to investigate. Note, however, that this duty does not necessarily have to be absolute.

The constructive notice theory places emphasis on the notion that registered
information can be invoked against a third person, even if that person was ignorant of the information. It imposes an absolute duty to investigate and in light of this duty, it interprets the phrase “any reasonable cause” very narrowly. Advocates of the theory assert that “a reasonable cause can include a situation in which one would not be able to know the registered matter, even if one paid reasonable attention to performance of the duty to investigate the Commercial Register; but a reasonable cause should not be concerned with whether or not a reasonably careful merchant would investigate the Commercial Register in any given case” [12].

The two basic premises of the constructive notice theory – an obviousness of proposition I and an absolute duty to investigate the Commercial Register – are questionable. First, can it simply be assumed that information required to be registered ought not to be invoked against a third person who was, in fact, ignorant of it? In a modern society, it is necessary to promote the security and efficiency of transactions by protecting a bona fide third party in many situations; but the requisite for such protection is usually that the party neither knew the matter nor was guilty of (gross) negligence in not knowing it. Protection of a third party solely on the basis of his ignorance of the matter is rather unusual in Japanese law. Moreover, although protection of a bona fide third party who was not guilty of (gross) negligence is afforded in many provisions, it should be regarded as rather an exception to a principle. The fundamental juristic-action principle is that a person can invoke a fact against a third person, whether such other person knew the fact or not, so long as it actually occurred. For example, if a person entered into a contract as a representative of another person at a time when he no longer held representative authority, the other party to that contract cannot be protected, whether or not he knew or ought to have known of the absence of authority, because the contract itself is legally invalid as a consequence of the absence of authority on the part of one of its parties. The practical result of invocation of this theory would be the obstruction of the security and efficiency of the underlying transaction. Consequently, Japanese law protects a party who relied on the external appearance of (valid) authority. This concession to practicality constitutes a modification of or departure from the juristic action principle. Similarly the first sentence of article 12 is not at all a natural rule, but rather, also an exception to the fundamental principle of juristic action.

Secondly, the question arises whether it is proper in the first place to impose upon the third person an absolute duty to investigate the Commercial Register. This presupposition of the constructive notice theory is at the heart of the unreasonableness of the Supreme Court’s decision because it is too severe: a third person ought not to be required to investigate the Commercial Register every time he is about to transact business with a merchant. In this respect, commercial registration differs from real estate registration. In the latter, a person must register an acquisition of a real right over a piece of real estate in
order to invoke it against a third person. Accordingly, he will be sure to investigate the Real Estate Register every time he engages in a real estate transaction with another party. In the former, however, a person usually wishes to investigate the Commercial Register when he begins serious transactions with a merchant with whom he has never transacted before, or when he has some reason to be suspicious of the merchant; he does not feel the need to investigate the Register every time he wants to do business with a merchant. The imposition on such a person of an absolute duty to investigate the Commercial Register is too great a departure from this customary level of attention and ignores what most people are able and willing to do in the course of day-to-day economic life.

4. Different dimension theory

In view of the foregoing discussion, how should article 12 be construed and what is the relationship between the provisions designed to protect reliance on external appearances (e.g. Civil Code article 112, Commercial Code article 262) and the general effect of the commercial registration system? How should the Supreme Court have decided the case in order to arrive at a logical, reasonable and practical result? The author believes we should start from the fundamental principle of Japanese law that a person can invoke a fact so long as it actually occurred.

As indicated in the previous section, the first sentence of article 12 is an exception to this principle, and it can be explained as follows. Before one takes legal action, he considers many matters vis-à-vis the other party, including capacity, authority and scope of representation, and financial resources. Determination of and investigation into these matters are difficult, however, especially today because the mechanisms for transactions are so complex. So, to simplify matters, the Commercial Code employs the commercial registration system which requires every business entity to register or give public notice of certain important matters.

In order to effectuate this public notice objective of the system, the entity or merchant must file the necessary registration documents. Many means are conceivable for encouraging compliance. For instance, the entity or merchant could be threatened with criminal or civil punishment for failure to comply. An even more effective incentive would be to link failure to comply with private law consequences. One such private law consequence is to make registration by the entity or merchant a prerequisite for its invoking juridical action against a third party [13]. The first sentence of article 12 seeks to effectuate the public notice function in just this way. Therefore, once the merchant registers the information required to be registered, there is no longer any reason to treat him disadvantageously. And once the information is

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registered, it can be invoked by him against any third person.

The first sentence of article 12, designed to effectuate the public notice function of the commercial registration system, and articles 112 and 262, designed to protect reliance on external appearances, represent different dimensions of and approaches to the basic liability questions presented in the Supreme Court case. In order to compel performance of the obligation to enter important information in the Commercial Register, the first sentence of article 12 prescribes the requisite for invoking a matter against a third party by forbidding invocation of a fact not yet registered. The external appearance provisions, on the other hand, are not concerned with publication of information, but rather with the security and efficiency of commercial transactions; they achieve this goal by approving the results that would have occurred if the apparent representative authority had actually been a fact. Therefore, the first sentence of article 12 does not contradict the provisions to protect reliance on external appearances. After the resignation of a representative director is registered, and then the exceptional treatment which is engendered from the public notice objective ceases, another exception to the fundamental principle, engendered from the objective to protect reliance on external appearances, may be effectuated.

Notwithstanding these different thrusts in the law, the very existence of the commercial registration system affects the ability of the law to protect reliance on external appearances. This is so because by virtue of the existence of the Commercial Register there exists the possibility of becoming informed of certain matters. And so long as this possibility exists, a third party can potentially be deemed (grossly) negligent.

The question then arises: To what extent should a person who did not investigate the Commercial Register and who entered into the transaction with a misunderstanding of the facts be protected by the provisions that permit reliance on external appearances? Certainly, he should not be burdened with an absolute duty to investigate the Register. Therefore, we should not presume that a person who did not know a fact that could have been learned from the Register is necessarily guilty of negligence or gross negligence. Any answer to the question must serve to regulate the conflicts of interest between that person and the merchant; it must also promote the security and efficiency of the underlying commercial transaction.

5. “Any reasonable cause”

Even if we rationalize the law using the different dimension theory introduced above, there remains the troubling question of how to interpret the “any reasonable cause” defense provided by the second sentence of article 12. The author maintains that the phrase should be interpreted elastically, to include
the case where there exists an external appearance of authority. However, article 262 itself ought not to be considered one such reasonable cause.

The phrase “any reasonable cause” has been interpreted very narrowly because of the presumption of an absolute duty to investigate the Commercial Register. If this absolute duty were not presumed, the phrase could be interpreted more broadly. And if the phrase were interpreted more broadly, the second sentence of article 12 would surely function as one of the provisions that protect the reliance on external appearance, notwithstanding that the external appearance thereby protected would not be confirmed by what was contained in the Commercial Register.

Another difficulty would arise, however, if “any reasonable cause” were interpreted elastically. The provisions that protect reliance on external appearances usually demand not only that a third party neither knew the fact nor was guilty of (gross) negligence in not knowing it (subjective requisite) but also that there were circumstances for which the interested party was to blame (objective requisite). For example, under article 262 a corporation is liable if it invests an apparent representative director with a title from which it might be assumed that he had authority to represent the corporation; under article 112 a principal who had invested another person with representative authority is liable if he did not inform the third party of the lapse of the authority. By requiring both the objective and the subjective requisites, articles 262 and 112 have been able to regulate the conflicts of interest between the parties. However, if the second sentence of article 12 is interpreted literally, the result is that the third party need only establish a reasonable cause for his ignorance. If the third party who relied on an external appearance (other than the Commercial Register) can prevent the invocation of the registered information against him merely by contending and proving that there was no negligence on his part, the result would be too harsh on the party who did register the matter, and it would be too protective of the third party.

In fact, this problem may well be one of the reasons for the development of the constructive notice theory and the presumed absolute duty to investigate the Commercial Register. Dr. Takeda, who developed the theory, himself admitted that, in the first place, a third party is not usually obliged to investigate the Commercial Register, and ignorance of the registered fact cannot always be attributed to negligence. However, he feared that “if we admit this, an aim of this public institution of the Commercial Register might be almost effaced”; therefore, he proposed the presumption of an absolute duty to investigate [14]. It seems that his concern was to avoid overprotection of the third party. On the other hand, if an absolute duty to investigate the Commercial Register is presupposed and “any reasonable cause” within the second sentence of article 12 is interpreted very narrowly, the merchant who performs the obligation of registration is overprotected. Thus, no matter how the phrase “any reasonable cause” is interpreted, the result is undesirable. The
The author believes this to be inevitable because the sentence itself is not well drafted. Even if it were considered to be a provision that protects reliance on external appearances, the sentence is unusual in that it does not demand the objective requisite on the part of an interested party that there are circumstances for which he is to blame.

Moreover, the need to interpret the sentence as a provision to protect a third party is questionable because there already exist many private law provisions that achieve that result. The author thinks another such provision is unnecessary. Therefore, it is suggested that the sentence be repealed.

This proposal finds support in an explanation of article 12 by one of the article’s drafters [15]. The comment was made in connection with article 22 of the old Japanese Commercial Code of 1890:

[The old Commercial Code] seems, at its first sight, to be skillful legislation that harmonizes the conflicts of interest in that it attaches a relative effect to the registration by providing that a registered matter cannot be invoked against a third party who neither knew the fact nor was negligent; but it is deficient because it ignores the interests of a merchant who did register by providing such a weak effect which lasts for ever after the registration.

Consequently, the drafters of article 12 of the new Commercial Code “adopted the conclusion that a matter can be invoked, after the registration, against a third party who did not know it as well as against one who knew it”. However, fearful that “approving such absolute effect might cause an unfair result practically”, they indicated that “it is unavoidable to make an exception to that ordinary effect of the registration by providing that even after the matter has been registered and made public, an interested merchant cannot invoke a matter against a third party who had a reasonable cause for not being aware of the fact”. Thus, proof of having not been negligent for not knowing the fact, demanded by the old Commercial Code, was substituted for a proof of having had a reasonable cause for not knowing the fact; but the author doubts if there is any real difference between them.

6. Conclusion

Before such legislative reform to repeal the second sentence of article 12 is achieved, how can this incongruity in article 12 be rectified by means of its interpretation? One method is to narrow the interpretation of the phrase “any reasonable cause” and thereby limit the situations to which the sentence could be applied. This, in turn, would necessitate the presumption of an absolute duty to investigate the Commercial Register. At the same time, however, the provisions that protect reliance on external appearances should not presume such a duty.

The court decisions that pre-dated the 1974 Supreme Court decision did not
apply the constructive-notice theory, but rather, and in spite of article 12, the courts applied the provisions that protect reliance on external appearance. Furthermore, the courts often determined that failure to investigate the Commercial Register did not necessarily imply negligence [16]. It is also noteworthy that the second sentence of article 12 was interpreted very narrowly [17]. While this posture of the courts might be supported by the different-dimension theory, the tendency to presume existence of a different level of duty to investigate the Commercial Register when article 12 was involved and when the provisions to protect the reliance on external appearances were involved, was not reasonable. This is because there is no real difference between having had no negligence for not knowing the fact and having had a reasonable cause for not knowing the fact.

If it is impossible to ignore the second sentence of article 12, it might be best to interpret it by adding a requirement that the third person be blame-worthy for the circumstances that prevented him from knowing the facts. Practically speaking, applying the second sentence of article 12 in this way to some concrete case when other provisions to protect the reliance on external appearance also can be applied will not lead to a much different result than that which is obtained when only the other external appearance provisions are applied as long as their subjective requisite is that a third party was not guilty of negligence for not knowing the fact.
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Notes

[3] This theory was first proposed approximately sixty years ago by Dr. Takeda. Takeda, Shōgyōtōki no Kōryoku (1910) reprinted in Takeda, Shōhō no Riron to Kaishaku (1959) at 3.
[10] One scholar has proposed that article 112 should also be deemed an exception to article 12. On this basis, he criticizes the 1974 Supreme Court decision. See Tatsuta, Hōgaku Ronsō, vol. 97, no. 2 (1975) at 81, 85.
[12] Id.
[13] This would have the desirable effect of getting the merchant to comply with the law, while eliminating the possibility of injuring the third party.

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