THE RISKS OF BEING AN OSTENSIBLE DIRECTOR UNDER JAPANESE LAW

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1. Introduction

Suppose you accepted, upon request by a friend of yours, to be a director of a corporation, and your name appears as a director on the commercial registry. Suppose, however, the corporation does not take the steps necessary to elect you a director and you never engage in managing the corporation. The corporation, run by your friend, next falls into insolvency due to his mismanagement. A creditor of the corporation then brings an action for damages against you in order to recover the loss sustained by him, due to the corporation’s inability to satisfy his claim. Are you liable in a case like this under the law of your jurisdiction? In many countries, probably not. Under Japanese law, by contrast, you will be held liable for such damages.

In K.K. Nippon Sutadeo v. Nakamura [1], a non-party, Itoh, had persuaded his mother-in-law, Nakamura, to be a representative director of K.K. Tempōdō. Nakamura’s name was placed on the commercial registry as a director and representative director of the corporation [2]. However, neither the shareholder meeting nor the meeting of the board of directors was held to appoint Nakamura director and representative director of Tempōdō. Nakamura never participated in the management of the corporation, having been asked merely to be a nominal representative director, and also having been assured by Itoh that this would not involve her in any trouble. As its manager, Itoh administered all the affairs of Tempōdō at his will. Yet he was also a representative director of another corporation, Chiba Sangyō K.K., to which he had Tempōdō lend 50 million yen. Due to Chiba Sangyō’s insolvency, Tempōdō also became insolvent. Tempōdō owed plaintiff approximately 1.4 million yen for the work done by plaintiff in producing a commercial film for Tempōdō. Being unable to collect the claim from Tempōdō, the plaintiff sought damages from Nakamura. The plaintiff won at both the first and second instances, and the Supreme Court upheld the lower court’s decisions.

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The Supreme Court conceded that defendant Nakamura was not a director of Tempōdō; nonetheless, the Court held that Nakamura was liable for her failure to discharge a director's duty. In reaching this conclusion, the Court relied on two statutory provisions. The first provision was Article 14 of the Commercial Code, which provides as follows: "One who, knowingly or by fault, had an untrue matter registered may not claim as against bona fide third parties that the matter it not true." This provision refers to the person who is obligated to apply for registration of certain matters; in Nakamura, this "person" was the corporation itself, Tempōdō. The Court applied the provision by analogy to Nakamura on the ground that she helped cause the untrue registration by virtue of her consent to be a director. Accordingly, Nakamura was stopped from claiming that she was not a director as against a plaintiff who was not aware of her true status.

The second basis relied on by the Supreme Court was Article 266-3 paragraph 1, of the Commercial Code, which states: "Where a director committed bad faith or gross negligence in performing the function, the director is jointly liable for damages also as against third parties" [3]. The Court did not specify Nakamura's misconduct, but merely stated that she was liable under such factual situations as found by the court below. The Tokyo High Court regarded it as the ground for Nakamura's liability that she did nothing to check Itoh's careless mismanagement.

The combination of these two statutory constructions resulted in imposing seemingly harsh liability upon a non-director vis-à-vis third parties. The Court created entirely new law in this respect. Many readers may feel uneasy with this result. As will be discussed below, although the decision has been criticized, most commentators support at least the Court's conclusion. This academic support is natural in light of certain backgrounds that have developed under Japanese law.

2. Backgrounds

2.1. Bubble Corporations

More than one million stock corporations presently exist in Japan, most of which are quite small. The fact that there is no statutory requirement for the minimum amount of stated capital may contribute to the popularity of the stock corporation form among small enterprises [4]. Not a negligible number of enterprises operate a business of substantial size by means of borrowed money. Thus, people often enter into transactions with these small enterprises, relying on the one person who runs the corporation. In the event of a corporate failure, creditors are prone to seek recovery from such person. Where the person has dominated the corporation, the doctrine of disregarding
the corporate entity may be a powerful weapon [5]. Problems arise, however, if the dominating person is also insolvent or his or her whereabouts are unknown. The statutory provision often resorted to in such an instance is Article 266-3 of the Commercial Code, which is applicable to all directors, regardless whether they are dominant or subordinate, or even nominal.

2.2. Director's Liability Vis-à-vis Third Parties

Article 266-3 of the Commercial Code is one of the provisions under which the largest number of cases have accumulated within the area of corporation law in recent Japan. In pre-war times the predecessors of the provision, Article 177 paragraph 2 of the Commercial Code (before 1938) and Article 266 amendments (before 1950) was applied to those cases where the director caused damage to the corporation through misconduct, such as appropriation of funds and resultant corporate loss that led to a creditor's inability to collect from the corporation [6].

Post-war cases extended the range of Article 266-3 beyond the classic types. Courts no longer care whether the corporation suffers a loss as a result of the director's misconduct, and they hold a director liable vis-à-vis third parties to the extent that the director has acted in bad faith or with gross negligence in connection with administering corporate affairs. For instance, where a director makes a promissory note on behalf of the corporation when he has doubt about the corporation's financial ability to honor the note, the director is held liable for damages as against the holder of the dishonored note [7].

In cases of this sort, the corporation itself does not suffer a loss as a direct result of the director's misconduct, aside from damage to its reputation, since the corporation receives something valuable in exchange for the dishonored note. Some commentators argue that “bad faith or gross negligence,” as stipulated in Article 266-3, relates to the director’s unlawful act directly addressed to the third-party victim, because the director’s conduct – e.g., making a note – does not amount to mismanagement. This analysis has led to two opposing views: (1) Article 266-3 is applicable only where a director injures a third party without causing damage to the corporation – in other words, the article is nothing but a special provision of tort law; (2) Article 266-3 applies only to classic cases where a third party suffers loss as a result of corporate insolvency caused by the director’s mismanagement, in other words, the Article is a special provision for creditors’ subrogation, with the redress of direct unlawful acts by directors being left to the application of general tort provisions [8].

In Izuo Kōzai K.K. v. Mutoh [9], however, the Supreme Court, by its Grand Bench decision, held: first, Article 266-3 is applicable to both those situations irrespective whether there was an intermediate cause of corporate damage; secondly, “bad faith or gross negligence” relates to malperformance of the
directorial function; and thirdly, the Article is to be regarded as a statutory provision _sui generis_, not a special provision of tort law. This view is now supported by most academic commentators.

2.3. Liability for Nonperformance: Nominal Directors

In _Mutoh_, the defendant was a busy man engaged as a patent adviser, veterinarian, and member of a prefectural assembly. He had been asked by a Kōketsu to be a representative director of Kikusui Kōgyō K.K. for the purpose of heightening the corporation’s reputation. In contrast to the facts of _Nakamura_ [10], Mutoh was duly elected a director and a representative director. He visited the office of Kikusui Kōgyō only a few times during his directorship of several months, as he was allowed by Kōketsu to abstain from performing a director’s duty. Kōketsu, also a representative director, administered all the business of Kikusui Kōgyō at his will. The corporation purchased some steel products from the plaintiff and made a promissory note for the payment thereof. The note was dishonored, and the plaintiff brought an action for damages against Mutoh and Kōketsu. At both the first and second instances, the two defendants were held liable. Mutoh alone made jōkoku appeal to Supreme Court. According to the Court, Mutoh, as a representative director, was obligated to prevent another representative director, Kōketsu, from committing grossly negligent managerial acts, e.g., making a note without the prospect of its being honored when due. Mutoh’s failure to meet this obligation by letting Kōketsu administer every affair of the corporation constituted Mutoh’s own gross negligence.

The duty to supervise the management and to prevent the management from engaging in mismanagement is owed not only by a representative director but also by all directors. Thus, although a mere director who is not a representative director has neither the power nor duty to carry out corporate business, such a director is empowered to convene a meeting of the board in order to prevent or correct mismanagement by warning or even removing the representative director. Failure to act under such circumstances would amount to the director’s breach of his or her duty and may make the director liable for the management’s misconduct which is detrimental to third parties [11].

The director may well be held liable if he or she fails to take any steps while cognizant of the management’s misconduct. If the director is unaware of the misconduct, how can he or she be motivated to take a step necessary to prevent it? The fact that the director is only nominal and fails to discharge any duty as a director constitutes a grossly negligent breach of his or her duty and may trigger application of Article 266-3.

Why then does one take a position as a nominal director? One may answer, because of one’s highly regarded reputation, to be a decoration of the corporation. Such a request would not be easy to refuse if made by an intimate
friend. Renumeration may be attractive in some cases. With regard to small enterprises, the minimum number of three directors required by the statute for a stock corporation may also give rise to the use of inactive directors. Many small corporations are sole proprietorships in reality. Thus, the founder wishes to and does run the business without the help or supervision of others. Consequently, a minimum number of directors are necessary only for the purpose of taking the form of a stock corporation [12]. It may be wise for a nominal director, in such a case, to stay inactive in order to keep good relations with the founder.

Once an enterprise, however small it may be, has taken the form of a stock corporation, it is no doubt obliged to abide by the provisions of corporation statutes. Once the position of director is assumed, the duty of the director must be discharged, no matter what the founder actually expects from the nominal director. The fact that the director has no experience in the business, that he or she does not fit well into the position, or that he or she is too busy to work for the corporation should be the reason for him or her to decline to be a director, but it cannot be an excuse for failure to fulfill a director's duty.

Even though one may generally be held liable for abstention from performing a director's function on the ground that he or she has agreed to assume the office, the issue remains whether it is reasonable to distinguish cases like Nakamura only because they have lacked formal procedures to appoint directors.

3. Liability of Ostensible Directors

3.1. Nominal or Ostensible

For the sake of brevity, it will be convenient to use the following definitions: a "nominal" director means a director duly elected but with an understanding, like Mutoh's, not to perform a director's function whereas an "ostensible" director refers to a person who, like Nakamura, has agreed to be a director and appears on the commercial registry but does not hold the position of a director. The critical difference between the two terms is that a nominal director is a director in the legal sense (*de jure* director), whereas an ostensible director is not a director. On the other hand, the two terms are alike in that both nominal and ostensible directors have agreed to be directors, that both appear as directors on the commercial registry, and that both do not actually work as directors.

The term "ostensible director" is not limited to application to a person like Nakamura who has never been elected a director. It also embraces a person who was a *de jure* director and whose name continues to appear on the commercial registry after retirement.
3.2. Liability of a Non-director

One of the criticisms of Nakamura is based on the distinction that an ostensible director has neither the power nor duty of a director. Even if Nakamura had been aware of Itoh's misconduct, she had no means to prevent or correct it. Thus, Nakamura had no duty to monitor Itoh's conduct and the failure to prevent the latter's misconduct could not constitute a breach of duty [13]. In its decision, the Supreme Court reasoned that, as a result of untrue registration brought about by Nakamura's acceptance, she was stopped from denying that she was a director. Consequently, she was to be treated as if she had been a director.

3.3. De Facto Director?

There are cases where the conduct of a non-director is legally assessed as a director's conduct by virtue of the doctrine of de facto director. Under the de facto director rule, the effect of the non-director's conduct is attributed to the corporation. Japanese law has developed several principles to protect bona fide third parties by affirming the validity of a transaction made by a non-director. For instance, if the resolution of a shareholder meeting electing a person to be a director is revoked due to, say, a procedural defect, the person is deemed not to have been a director from the outset. A non-director cannot be a representative director. The transaction the person made as a representative director on behalf of the corporation before such revocation, however, remains valid without being affected by the revocation. This construction derives from applying Article 14 of the Commercial Code, the provision with regard to untrue registration.

Another device to protect bona fide third parties is application by analogy of Article 262 of the Commercial Code on an apparent representative director to a non-director. Article 262 stipulates as follows:

The corporation shall be liable vis-à-vis bona fide third parties for the conduct made by a director to whom the corporation has conferred a title regarded as implying the power to represent the corporation such as president, vice-president, senior managing director or managing director, even where the director did not have the power to represent the corporation [14].

A literal interpretation of Article 262 precludes applying the provision to a non-director. The Supreme Court, however, applied the provision by analogy to a transaction made by an employee who was allowed to call himself a managing director, and held that the corporation was bound by the transaction [15].

At any rate, these techniques are used to hold the corporation liable for the conduct made by a non-director. It would not be unreasonable to make use of the de facto director concept for the purpose of holding the actor liable. For
example, where a person who has never been elected a director or who has already retired commits an act to the detriment of third parties in connection with managing the corporation, the person may be held liable under Article 266-3, on the ground that he at one time was, and therefore exercised the power of, a director [16].

Where, however, the person has never acted as a director [17], it would be difficult to embrace him within the concept of *de facto* director. Nonetheless, taking into consideration the vital importance of commercial registration under Japanese law, one commentator has extended the notion of *de facto* director to include those who do nothing but give consent to appear on the commercial registry as a director [18]. Yet insofar as it is necessary to resort to the commercial registration, it seems to be a mere semantic question whether to call such a person a *de facto* director.

3.4. Only Bona Fide Third Parties?

One may argue that Article 266-3 imposes liability on the basis of director status rather than for the purpose of protecting *bona fide* third parties, and that it makes no sense from the third party’s viewpoint to question whether the director was duly elected or not. This argument leads to the assertion that third parties should be allowed to utilize Article 266-3, no matter whether they are aware of the fact that the director was not duly elected [19].

Although it is true that Article 266-3 is a provision for liability *sui generis*, or special tort liability, by no means does it provide for contractual liability. To the extent that this provision is concerned, it does not matter whether the third party relied on the director’s status. That is why it sounds awkward to apply this provision via Article 14, which purports to protect those who relied on an untrue registration.

In order to avoid resorting to the application of Article 14, one commentator has suggested another provision to hold an ostensible director liable, Article 266-3 paragraph 2, which stipulates as follows:

A director shall also be liable as provided by the preceding paragraph where the director made a false entry with respect to material items to be stated in a stock subscription form, a warrant, a debenture subscription form, a prospectus or documents prescribed in article 281 paragraph 1 (financial statements), or caused a false registration or public announcement; Provided, however, that the director shall not be liable if he or she proves that he or she did not fail to take due care in making such entry or in causing such registration or public announcement [20].

This provision also refers to a director duly elected. According to the commentator, an ostensible director would be subject to application by analogy of this provision by virtue of his or her consent to be registered as a director [21]. Thus only those third parties who relied on the false registration may assert the applicability of this provision, since, otherwise, a causal relationship could
not be found between the false registration and the harm to the third party [22].

It would be unfair to grant relief to a third party who was aware that the defendant was not a director [23]. For the third party entered into a transaction with the corporation, not with a director. The third party only seeks recovery from persons other than the party to the transaction because of its inability to collect from the corporation. In this light, the third party should not be allowed to regard a person as director despite the third party's awareness that the person was not a director.

On the other hand, it would be too narrow a construction to limit relief to only those third parties who inspected the commercial register. Article 266-3 paragraph 2 does not demand such a narrow interpretation. As for a prospectus, for instance, even those who have not read it are entitled to seek damages on account of a material misstatement in it, to the extent that they relied on the misinformation derived from the prospectus. With regard to Article 14, the prevailing view is that those who have not inspected the commercial register also enjoy protection afforded by the provision, to the extent that they were not aware that the registration was untrue [24].

4. Conclusion

The construction developed by the Supreme Court in Nakamura seems more persuasive than other theories of construction proposed by commentators. At first glance, the combination of Commercial Code Article 14 and Commercial Code Article 266-3 paragraph 1 seems strange. Nevertheless, the law created by the Court comports with the reality of the Japanese economy. The legal status of a nominal director resembles that of a surety or guarantor for the corporation, as a result of accumulated cases that widely apply Article 266-3 paragraph 1. Third parties are right to look for such a guarantor after the occurrence of corporate insolvency. It would also be logical for third parties to look for a person who is estopped from denying his or her own directorship on the ground that the position is almost equivalent to a suretyship. Yet in doing so, third parties themselves must be free from self-contradiction, i.e., they should not be able to contend that a person was a director who they knew was not. In other words, only those who were not aware that the registration was untrue should be allowed to use the fact of the untrue registration in their claim for recovery.

To lend one's name to a corporation's list of directors thus is quite risky under Japanese corporation law. The mere appearance of one's name as a director on the commercial registry may expose one to liabilities vis-à-vis unknown people. Yet there are ways to reduce the possibility of liability. For instance, a person should decline to give consent to be a director when that
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person is not expected to act as such. After agreeing to assume the office of a director, one should be sure to be duly elected, and then make full use of the power of a director in order to prevent or correct mismanagement by fellow directors. As soon as one resigns from a director's position, that person should make sure that his or her name no longer appears on the commercial registry. As long as one firmly requests that the management delete the person's name from the registry, that person will be safe even in relation to bona fide third parties.

Notes

[2] A corporation must have three or more directors (torishimariyaku), who are members of the board. A representative director (daihyô torishimariyaku), appointed by and from among the board members, executes board resolutions and daily business. The names of the directors and the name and address of a representative director must be registered. Shôhô (Commercial Code), Law No. 48 of 1899, art. 188, ¶ 2, items 7 & 8; art. 255; art. 261, ¶ 1.
[3] The text shows the present version of Article 266-3 paragraph 1. Before the amendment of 1981, the same paragraph contained another provision with regard to liability for misrepresentation, which is now paragraph 2 of Article 266-3, with some modifications.
[4] The 1981 amendments to the Commercial Code increased the amount of a stock from 500 to 50,000 yen, without regard to whether it is of par value, as long as it is issued at the time of the corporate formation. Shôhô art. 166, ¶ 2, art. 168-3. At least seven incorporators are necessary to form a stock corporation. Shôhô art. 165. As a result of these statutory requirements, the minimum amount of stated capital is 350,000 yen, which is about 1,750 United States dollars (assuming 1 dollar = 200 yen). Before the enactment of the 1981 amendment, a stock corporation could be formed with stated capital of 3,500 yen, approximately 20 U.S. dollars. Small, closely held enterprises are supposed to take the form of limited liability corporations (yûgenaisha, GmbH, SaRL). 100,000 yen has been the minimum amount of stated capital for this type of corporation since the 1951 amendments, which is sort of a contradiction in comparison with stock corporations (kabushikigaisha, AG, SA). Yûgenaishahô, Law No. 74 of 1938, art. 9 (law of Limited Liability Corporations). In addition to these two types of capital corporations, the Commercial Code provides for two types of personal corporations: partnership corporations (gomeigaisha, OHG, société en nom collectif) and limited partnership corporations (gishigaisha, GK, société en commendite simple), both of which exist as corporate entities separate from their members.

According to the Ministry of Justice, the number of each type of corporation (excluding those under liquidation proceedings) were as follows, as of July 1984:

<table>
<thead>
<tr>
<th>Type of Corporation</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>stock corporations</td>
<td>1,120,834</td>
</tr>
<tr>
<td>limited liability corporations</td>
<td>1,059,692</td>
</tr>
<tr>
<td>partnership corporations</td>
<td>19,770</td>
</tr>
<tr>
<td>limited partnership corporations</td>
<td>80,756</td>
</tr>
</tbody>
</table>

Inaba, Daishogaisha Kubunrippo Ni Kansuru Shomondai 11 (Bessatsu Shôjihômu No. 73, 1984) (problems pertaining to legislation distinguishing small corporations from large ones). Of more than one million stock corporations, only 3,035 (0.27%) had stated capital of one billion yen or more, and corporations with stated capital of less than ten million yen amounted to 815,589
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(72.38%). Id. The Legislative Council (Hōsei Shingikai) is considering a reform to create a statutory minimum of stated capital for stock corporations, and to increase substantially such a minimum for limited liability corporations. Small businesses resist enactment of these amendments.


[6] See, e.g., Matsu v. Imanishi, 5 Minshū 115 (Great Ct. of Cassation, Jan. 20, 1926). Prior to the 1950 amendments, each director was entitled to manage and represent the corporation.


[10] See supra notes 1–2 and accompanying text.


[12] The Legislative Council is considering a decrease in the minimum member of directors from three to two with respect to small stock corporations. It is also considering a new provision relating to the liability of a shadow director.


[14] Shōhō art. 262.


[17] This is the situation at issue in Nakamura. See supra note 1 and accompanying text.


[22] Id. at 25.
