MAJORITY OWNERSHIP STRATEGIES FOR JAPAN

Michiko Ito Crampe*
and
Nicholas Edward Benes**

INTRODUCTION

For quite some time, businessmen in the U.S. and around the world have believed that opportunities for direct investment in Japan are extremely limited. However, if foreign companies are ever going to make a significant dent in Japanese markets, this appraisal must be constantly re-assessed in the light of the changing business and legal environments of that country. A year ago, the enactment of Japan's new Foreign Exchange and Foreign Trade Control Law laid the groundwork for lifting many of the old restrictions on foreign investment. This law was widely touted as "full liberalization", but it stops far short of that standard. Some observers have even questioned whether it changed anything at all. Since enactment of the new law, there has been a moderate increase in the flow of direct investments to Japan, while the interpretation of certain crucial ambiguities in its provisions has been in a state of flux. Resolution of these ambiguities is likely to be a gradual process of consensus-building both inside and outside of the government. Legacies from the protectionism of the earlier period exist not only in the mind-set of the bureaucracy, but also in the attitude of Japanese corporations, the capital structure of industry, and the tenor of public opinion in Japan. For foreign corporations to understand these legal and non-legal

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* Michiko Ito Crampe is an attorney admitted to the bars of Japan and New York. She is presently associated with the New York firm of Miller, Montgomery, Sogi & Brady. Mrs. Crampe holds an L.L.B. from the University of Tokyo and an L.L.M. from the University of Washington.

** Nicholas Edward Benes is the Editor-in-Chief of the *UCLA Pacific Basin Law Journal*. He is currently enrolled in the J.D.-M.B.A. joint degree program at the University of California, Los Angeles.

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factors is for them to aid in constructively interpreting the new law and to expand their operations in Japan at the same time.

The purpose of this article is to provide foreign companies with a practical guide for choosing a majority-owned vehicle for conducting business in Japan. It is hoped that this exposition will help both foreign as well as Japanese interests to resolve their differences and meet their respective goals. The emphasis is on fully-controlled forms of organization because the new foreign investment law at least nominally opens up new opportunities in this regard. The following organizational strategies shall be considered: (a) formation of a branch office, (b) establishment of a wholly-owned subsidiary, (c) establishment of a joint venture in which the foreign investor has a controlling interest, and (d) acquisition of an existing Japanese corporation. The article will first discuss the constraints of the foreign investment laws, then proceed to an analysis of the overall business environment for each form of organization, and finally treat the most important tax aspects of each strategy.

I. REGULATIONS UNDER THE FOREIGN EXCHANGE AND FOREIGN TRADE CONTROL LAW

Though it is difficult to compare the figures, in the past the level of foreign investment in Japan has been low compared to other advanced countries.[1] Despite the fact that corporations in most countries prefer the wholly-owned subsidiary as a vehicle for direct investment abroad, throughout most of the postwar period Japan imposed legal restrictions which sharply discouraged foreign businesses from establishing wholly-owned subsidiaries. Particularly in the industries where foreign firms were likely to hold a competitive edge, participation in the Japanese market was often limited to minority or 50% interests in joint ventures, sales through trading companies or sales agents, or technology licensing agreements with Japanese firms. Consequently, foreign stockholdings in Japanese businesses remain small.[2]

However, many of the regulations controlling and limiting di-

1. In 1977, companies with 25% or more foreign stock equity accounted for 4.64% of total manufacturing sales and 2.15% of total business sales in Japan. 12 GAISHIKEI KIGYŌ NO DŌKŌ (Trends in Foreign-Affiliated Enterprises) 17 (MITI, 1978). *See also* note 2, *infra*.

2. It has been estimated that as of September, 1980 (just prior to implementation of the FECL), foreign investors held about 4% of all Japanese stocks at current prices. During approximately the same period, the figures for the U.S. and West Germany were 6.7% and 9.9%, respectively. Round Table Discussion, *Kabunushi Kokusaika Jidai to Kigyōkeiei o Kangaeru* (Thinking about the Age of Internationalization of Shareholding and Enterprise Management) 894 SHŌJI HŌMU (Practice of Commercial Law; hereinafter cited as "SHŌJI HŌMU") 12 (1981).

rect investments in Japan have been dismantled over the past decade. Effective December 1, 1980, culminating over 15 years of foreign pressure to liberalize its laws pertaining to foreign exchange and investment, Japan repealed the restrictive Foreign Investment Law[3] (the "FIL") and began enforcing the new Foreign Exchange and Foreign Trade Control Law[4] (the "FECL") and its implementing regulations. The provisions of the FECL are based on the general principle that all external transactions (a term which comprises direct investments) should be free of control unless an "emergency" or special exception is deemed to apply. This approach is a reversal of the fundamental concept underlying the FIL that external transactions should generally be restricted except where permission is granted. For this reason, the FECL is sometimes heralded as "100% liberalization", which it is not. Even under the FECL, certain controls remain in place or could be reinvoked. The most important of these are described below.

A. Prior Notification Requirements for Establishments and Acquisitions

Before the enactment of the FECL, the establishment of a subsidiary and the acquisition of a substantial interest in an existing Japanese corporation by a "foreign investor" were regulated by the FIL (a "special law") and not the old FECL (a "general law"). Formation of branch offices was covered by the FECL. In the current amendment, the FIL has been integrated with the FECL, but these transactions have been labeled "direct domestic investment" and are treated separately from other capital and service transactions.

The old laws have been aptly described as "labyrinthine". Unfortunately, the new codification has not accomplished much in the way of simplification. Under the provisions of the new FECL, if a person or organization falling within one of four classifications undertakes one of the activities denoted as "direct domestic investment", he, she or it will be deemed to be a "foreign investor" and as such will be subject to the advance notification requirements. The four classifications are:

(i) an exchange non-resident individual, i.e., a natural person not having his or her domicile or residence in Japan;[5]
(ii) a juridical person or other organization which is established under foreign law or has its principal office of busi-

3. *Gaishi ni Kansuru Hōritsu* (Foreign Investment Law) (Law No. 163 of 1960; hereinafter, "FIL").

4. *Gaikoku Kawase oyobi Gaikoku Bōeki Kanrihō* (Foreign Exchange and Foreign Trade Control Law) (Law No. 228 of 1960, as amended by Law No. 163 of 1979; hereinafter, "FECL").

5. FECL, *supra* note 4, art. 6(1)(v)(vi); art. 26(1)(i); art. 6(1)(vi).

ness in a foreign country;[6]

(iii) juridical persons in which the majority of director positions (or the right to representation by such directors) are filled by exchange non-resident individuals;[7] and

(iv) a Japanese corporation in which 50% or more of the shares or stock equivalents are held by a foreign juridical person or exchange non-resident directly and/or indirectly through another Japanese corporation or corporations. The percent of indirect ownership is calculated by multiplying the percentage of each "other corporation" that is held directly by non-residents or foreign juridical persons (but only if greater than 50%) by the number of shares that corporation holds in the putative "foreign investor" company. Direct and indirect foreign ownership is then added together to arrive at a final figure which is compared to the 50% test ratio.[8]

Chapter 5 of the FECL is devoted to "direct domestic investment, and defines the most significant parameters of that term to be:[9]

(i) the acquisition of shares or a proprietary interest in a juridical person which is not a listed corporation (i.e., a company listed on one of the Japanese stock exchanges or sold over the counter);

(ii) the acquisition of shares in a listed corporation, where after the transaction the acquirer's holdings, plus the holdings of another juridical person (or persons) who stands in a "special (affiliated) relationship"[10] to the ac-

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6. *Id.* art. 26(1)(ii).

7. *Id.* art. 26(4)(iv).

8. *Id.* art. 26(1)(iii); *Tainai Chokusetsu Tōshinado ni Kansuru Seirei* (Cabinet Order Concerning Direct Domestic Investment) art. 2(1) (Cabinet Order No. 261 of 1980; hereinafter, "Direct Investment Cabinet Order"). *See* Anderson, *Japan's Foreign Exchange and Foreign Trade Control Law: The Story Unfolds-II*, 3 EAST ASIAN EXECUTIVE REPORTS 3 (1981).

9. FECL, *supra* note 4, art. 26(2). This is not a complete listing of the forms of "direct domestic investment", as it omits the provisions regarding acquisitions of corporate debentures or investments in juridical persons established by special law. *See* Direct Investment Cabinet Order, *supra* note 8, art. 2(1), (9).

10. An acquirer and an "other juridical person" are deemed to be in a special relationship whenever:

(i) one of them directly holds 50% or more of the stock or interest in the other;

(ii) one of them either wholly owns a juridical person which holds at least a 50% interest in the other, or holds at least a 50% interest in a juridical person which wholly owns the other;

(iii) the acquirer is 50% owned by a juridical person having at least a 50% interest in the other juridical person;

(iv) the other juridical person is wholly owned by (a) a potential "other juridical person" which indirectly holds at least a 50% interest in the acquirer by the rule of (ii), or (b) the potential "other juridical person" in (iii);

(v) both the acquirer and the other party are agencies of a foreign

quirer, equal 10% or more of the total outstanding stock of the listed corporation;

(iii) an agreement to affect a substantial change in the business objective of a corporation which is entered into by a foreign investor and a corporation in which the investor holds one-third or more of the shares or other interest;

(iv) the establishment of a branch office in Japan, or the affecting of a marked change in the business objective of a preexisting branch,[11] or

(v) a loan of 100 million yen or more, having a term exceeding one year, which is extended to a juridical person which has its principal business office in Japan. Notably, exempted from this provision are: (a) loans made by a bank or other organization which primarily engages in money lending, and (b) yen loans made by a juridical person which would be deemed to be a "foreign investor" either because of the makeup of its board of directors or because of its ratio of foreign-source equity capital.[12]

It will readily be seen that (iv) covers branch establishments, (i) covers the establishment of subsidiaries and joint venture companies, and (ii) covers corporate acquisitions of listed companies.

Before engaging in a transaction which would constitute any of the aforementioned forms of "direct domestic investment", a foreign investor-to-be must notify the Japanese government of his intentions and allow it to investigate the impact of the proposed investment.[13] Presumably, the use of a "notification" procedure instead of the old "validation" routine is intended to imply that the majority of investments are now unrestricted. Where branch, subsidiary, or joint venture establishments are contemplated, this advance notification requirement will not ordinarily pose a significant obstacle to the transaction. However, where the foreign investor is planning to acquire a listed corporation, the FECL has been drafted so as to permit the bureaucracy to bar the transaction

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government. Direct Investment Cabinet Order, *supra* note 8, art. 2(4), (5).

11. The following businesses are excluded from application of this provision because their respective regulatory laws already require advance government approvals: (a) banks and long term credit banks, (b) foreign insurers, (c) gas and electric companies, and (d) foreign securities companies. Direct Investment Cabinet Order, *supra* note 8, art. 2(6).

12. FECL, *supra* note 4, art. 26(2)(vi); *Tainai Chokusetsu Tōshinado ni Kansuru Meirei* (Order Concerning Direct Domestic Investment) art. 2(1) (Joint Order No. 1 of Nov. 28, 1980, by the Ministries of Finance; International Trade and Industry; Welfare; Agriculture, Forestry, and Fisheries; Post; Labor; and Construction; hereinafter cited as "Direct Investment Order"). *See* (iii) and (iv) in the definition of "foreign investor", at the text accompanying notes 5, 6, 7 and 8. The exclusion in (iv) enables a foreign parent corporation to make loans to a subsidiary in Japan without running afoul of the notification requirement. At the present exchange rate of about ¥230 to the dollar, ¥100 million is approximately $435,000. *See* text accompanying note 100 *infra*.

13. FECL, *supra* note 4, art. 26(3).

in certain cases. The details of this division in treatment are fleshed out in the sections that follow.

1. *Branch, Subsidiary, or Joint Venture Investments.* No more than three months prior to the date of a capital transaction made for the purpose of establishing a branch, subsidiary, or majority-owned joint venture, a foreign investor is required to give advance notice of his plans to the Minister of Finance and the Minister having jurisdiction over the industry involved.[14] Such notice must be given by means of an "exchange resident proxy".[15] Among other things, the notice must set forth the name, address, nationality and occupation of the foreign investor (in the case of a juridical person or other organization, the name, principal office address, type of business operations, and amount of capital of the organization); the purpose of the business relating to such investment; the time of consummation of the investment; and the reason for making the investment.[16] A foreign investor is prohibited from going forward with the investment for a period of 30 days after giving such notice.[17]

During the waiting period, the Ministers have an opportunity to investigate the investment for any adverse impact it may have.[18] In making this investigation, the Ministers are required to consider whether the investment

(i) will endanger national security, hinder the maintenance of public order, or hamper the protection of public safety;[19]
(ii) will have a significant adverse effect on the activities of Japanese enterprises in the same or related industries or impede the "smooth operation" of the Japanese economy;[20]
(iii) should be modified or suspended for reasons of mutuality vis-a-vis a nation with which Japan has no treaty obligations regarding restrictions on direct investments[21], or
(iv) should be modified or suspended because the Minister of Finance has decided to protect the balance of payments, the Japanese yen, or financial and capital markets in Japan by requiring governmental permission for that kind of capital transfer.[22]

14. *Id.* Usually, the latter would be the Minister of International Trade and Industry. Hereinafter, this Ministry will be referred to as "MITI" and the Ministry of Finance will be referred to as "MOF".
15. Direct Investment Cabinet Order, *supra* note 8, art. 1(11).
16. *Id.* art. 2(12).
17. FECL, *supra* note 4, art. 26(4).
18. *Id.* art. 27.
19. *Id.* art. 27(1)(i).
20. *Id.* art. 27(1)(ii).
21. *Id.* art. 27(1)(iii).
22. *Id.* art. 27(1)(iv).

During the one-month period, if the Ministers determine that further inquiry is necessary, they are authorized to extend the waiting period to four months.[23] On the other hand, if it is clear at the time the notification is filed that the investment poses no problems by the aforementioned standards, they may shorten the waiting period to two weeks.[24]

If the Ministers conclude that the proposed investment is likely to have one of the adverse impacts listed above, they are bound to seek the opinion of the "Foreign Exchange Inquiry Council".[25] Like other advisory councils set up in Japanese administrative law, this is a group composed of "persons having academic experience" who are appointed by the Minister of Finance.[26] After consulting with the Council, if the Ministers remain firm in their convictions, they may "recommend" that the particulars of the transaction be altered or that the execution thereof by suspended.[27] This is an example of so-called "administrative guidance". Within 10 days following receipt of this recommendation, the foreign investor must notify the Ministers as to whether or not he agrees to comply with its conditions.[28] If the investor does so agree, the modified transaction may proceed immediately despite the statutory waiting period. If the investor does not agree to amend the offending terms of the transaction, the Ministers are authorized to "order" its modification or cancellation.[29]

Thus, as far as the constraints of the FECL are concerned, the establishment of a branch, joint venture, or wholly-owned subsidiary *should* be a relatively quick and convenient procedure. At least, this is how the new laws are supposed to work in principle if

23. *Id.* art. 27(1). If the Foreign Exchange Inquiry Council so requests, the waiting period can be lengthened to five months in all. *Id.*, art. 27(3).

24. Direct Investment Order, *supra* note 12, art. 6(2).

25. FECL, *supra* note 4, art. 27(2).

26. *Id.* art. 55-3(2). The FIL also had a provision requiring that members have "academic experience". The term is usually interpreted loosely; the old council was about half composed of prominent industrialists and half by professors, with no members coming from government. *See* D. HENDERSON, FOREIGN ENTERPRISE IN JAPAN 222, 223 (1973).

27. FECL, *supra* note 4, art. 27(2). "Recommend" is a translation of the Japanese term "kankoku", which in a statutory context connotes administrative guidance. The foreign investor is under no legal obligation to alter its plans, but if it fails to adequately respond to the recommendation, it may be ordered to modify or suspend them later on. At the very least, the foreign investor risks wasting valuable time if it does not comply. On administrative guidance in general, *see* K. YAMANOUCHI, GYŌSEI SHIDŌ (Administrative Guidance) (1979).

28. FECL, *supra* note 4, art. 27(4).

29. *Id.*, art. 27(7). In contrast to "recommendations", "orders" are viewed by Japanese legal scholars as having the weight of law because they are exercises of rule-making or legislative authority that statutes have delegated to administrative organs. *See* 2 J. TANAKA, GYŌSEIHŌ (Administrative Law) 58 (1981).

officials live up to the FECL's stated objectives ". . .to contribute to the sound development of the national economy. . .by regulating and controlling external transactions to the minimum extent necessary. . . ."[30] But if one disregards the procedural semantics of distinguishing between "notification" and "validation", many of the new rules are substantively identical to provisions which were contained in the old law. Whether the FECL is in fact a liberalization will depend on how the appropriate Ministers' enormous discretionary powers[31] to conduct investigations and make recommendations are actually exercised. More than anything else, this will affect the flow of investment "notifications" because it will establish a consensus among businessmen as to whether Japan is or is not living up to the noble objectives of the FECL and its OECD and other treaty obligations. In this sense, the mind-set and policy orientation of the Japanese bureaucracy are important variables to reckon with when planning an entry strategy. However amorphous these factors may seem, the situation in Japan does permit the formulation of a few guidelines for analysis.

First, the government will probably permit the great majority of small to medium scale investments for branches and subsidiaries to proceed unhindered. It will be difficult to argue that they pose any threat to Japanese businesses. Since enactment of the FECL, the average monthly dollar volume of direct investments to Japan has risen by about 30%,[32] and many of these new cases are wholly-owned subsidiaries. At this point, the fact that the in-

30. FECL, *supra* note 4, art. 1. The establishment of a one-month or even two-week time limit is not as important as one might think. A one-month rule existed before the FECL, but as an administrative rule instead of a statutory provision. Moreover, even under the present system, officials can stall applications by extensions up to five months, and even longer by refusing to formally "accept" them on grounds that they have been improperly prepared. *See* text accompanying note 74 *infra*.

31. In some ways the FECL has expanded rather than cut back the discretionary powers of the bureaucracy as compared with prior law. Unlike the FIL, the FECL treats branches as a form of direct investment. Whereas article 18-2(2) of the FIL required the "competent Minister" to "respect" (*sonchō*) the opinion of the Foreign Investment Council in granting validations, the FECL contains no similar provisions, requiring only that the Ministers "hear" the opinion of the Foreign Exchange Inquiry Council. Lastly, to one of the FIL's broadest standards allowing the "competent Minister" to refuse validations ("adverse effect on the rehabilitation of the Japanese economy"), the FECL has added a standard which is *specifically* protectionist in nature (adverse effect on Japanese enterprises in the same industry, FECL, *supra* note 4, art. 27(1)(ii)). *See* text accompanying note 20 *supra*. It may turn out that this addition makes the standard easier to apply in a restrictive manner.

32. Likewise, the average number of cases approved per month has risen by about 50% as compared with 1980 (for figures through Sept., 1981). Letter to Nicholas Benes from Yutaka Tokui, Deputy Director of the Foreign Capital Division, International Finance Division, Ministry of Finance, Nov. 12, 1981; on file with the UCLA PACIFIC BASIN L.J. *See also* The Japan Economic Journal, which prints monthly reports of direct foreign investments that have been allowed to proceed under the FECL.

crease has not been greater should probably be attributed to a continuing distrust and ignorance of Japan's investment laws among foreign businessmen. Even prior to the new law, small and moderate scale investments for 100% subsidiaries were regularly being validated, a fact that was not widely known at the time.

Second, if the foreign entrant or its proposed investment is of enormous size or has great technological impact, this will afford officials the chance to argue for modifications. Wise investors will therefore seek to avoid intensive growth strategies in favor of incremental growth, a style that is more suited to the Japanese business climate anyway. Japan will also continue to closely control investments in the five primary industry sectors (mining, petroleum, leather and leather processing, agriculture, forestry and fisheries) for which it has lodged reservations to the OECD Code of Liberalization of Capital Movements.[33] Where either size or product sector indicate that the authorities will not be kindly disposed to the contemplated investment, the applicant would be advised to negotiate a joint venture contract with a Japanese concern. This will have the effect of convincing officials that the foreign company can be kept under control. Another approach to the problem might be to exchange stock with an appropriate Japanese firm.

Third, in a nation where the government tends to perceive foreign enterprises as "awkward at best and disruptive at worst,"[34] it goes without saying that administrators will continue to judge the desirability of large-scale investments on the basis of whether the new entity will fit in with the Japanese industrial system. Will the new entrant cause unemployment in important political constituencies? Will it honor the strictures of formal and informal industrial policies, including cartels; will it cooperate with other producers when necessary; and will it contribute any special technology or skills to the Japanese economy? Will it be sensitive to the dualism of the Japanese economy and refrain from overpowering the bankruptcy-ridden stratum of subcontractors and small factories? In general, will the new firm respect the myriad of unwritten rules that dot the business landscape in Japan? Faced with a bureaucracy that asks itself these questions, foreign companies should do everything in their power to avoid an antagonistic

33. The Cabinet Decree carrying over these reservations into the new FECL simply states that the government will ". . .treat [these sectors] with care, just as has been done in the past. . . ." Previously, these sectors were subject to case-by-case screening, with the result that wholly-owned subsidiaries were not allowed and maximum limits on foreign ownership (commonly 50%, as in the case of mining) were prescribed. *Tainai Chokusetsu Tōshinado no Unyō Hōshin ni Tsuite* (Concerning Operative Policies for Direct Domestic Investment) (Cabinet Decree of Dec. 26, 1980).

34. HENDERSON, *supra* note 26, at 206.

or litigious posture and to convince the government of their good intentions. Even before setting foot in Japan, the serious foreign investor will want to carefully research MITI's plans for long and short-range industrial policy and assess its implications for entry strategy, perhaps by employing a business consultant in Japan.[35]

Fourth, there is little doubt that the concept of "full liberalization in principle" and the pressures of criticism and protectionism from abroad will have an increasingly positive impact on the attitude of top officials. The bureaucracy will probably continue to follow screening procedures and internal rules (*naiki*)[36] similar to those which were in force before. Thus, the important questions here are: (a) to what extent will the ministries react to foreign dissatisfaction—and a recent lawsuit concerning the FECL[37]—by forging a consensus on how to ease the application of the rules, and (b) will these policy changes filter down to the lower echelons of the bureaucracy?[38] Pressures for change will also come from within Japan. For instance, the undeniable fact of Japanese economic success and ability to compete, and recent developments in antitrust law and public opinion regarding the legality of "administrative guidance" and government-business cooperation, should also exhibit a softening effect.[39]

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35. *Id.* at 240-244; O.E.C.D., LIBERALISATION OF INTERNATIONAL CAPITAL MOVEMENTS: JAPAN 63-67 (1968). On industrial policy, *see generally "Vision for the 1980's": Basic Course of MITI's Trade-Industry Policy*, THE ORIENTAL ECONOMIST 12 (Nov., 1979). Future entrants to the Japanese market should keep themselves informed of matters appearing in TSUSANSHŌ KŌHŌ (MITI Gazette), which often publishes recently promulgated laws and ordinances affecting business along with the official MITI interpretation and policy with respect to each law, and provides a wealth of information about Japanese business and MITI's programs. *See generally* KŌSEI TORIHIKI IINKAI NENJI HŌKOKU (Fair Trade Commission Annual Report), which lists the current status of all government-approved cartels.

36. Among other things, there were procedures for dividing cases into "major" and "minor" (automatic validation) cases; for applying different standards where the industry was a "nonliberalized" one; and, apparently, for the modification of contract terms so as to favor Japanese competitors. The development of efficient screening processes was hampered by factionalism between MITI, the MOF, and the Foreign Ministry, and even between the numerous individual departments within MITI itself. *See* HENDERSON, *supra* note 26, at 215-52. Descriptions of each of MITI's departments and agencies are contained in MITI INFORMATION OFFICE, MITI HANDBOOK (1979).

37. This is the Katakura lawsuit; *see* text accompanying notes 60-84, *infra*.

38. Some observers have noted that it is often the lower ranks of the bureaucracy that are most imbued with an overprotective attitude of "us against them on a national scale". *See* ADAMS & KOBAYASHI, THE WORLD OF JAPANESE BUSINESS 232 (1969); HENDERSON, *supra* note 26, at 239.

39. *See* Note, Trustbusting in Japan: Cartels and Government-Business Cooperation, 94 HARV. L.R. 1064, 1076, 1080 (1981); Sanekata, Sekiyū Karuteru Hanketsu no Saikentō (Reassessing the Oil Cartel Case) 364 KŌSEI TORIHIKI (Fair Trade) 10 (1981); Round-table discussion, *Dokusenkinshihō to Gyōsei Shidō to no Kankei* (The Relationship between Administrative Guidance and the Antimonopoly Law) 366 KŌSEI TORIHIKI (Fair Trade) 4 (1981). Some Japanese industrialists have gone on

Lastly, there is not much that a rejected investor can do to get a quick remedy in court. Although the U.S.-Japan Treaty of Friendship, Commerce and Navigation[40] and other treaties[41] might present aggrieved investors with strong substantive arguments, the practicalities of pursuing a claim and obtaining a remedy are prohibitive. Public international law would require that the plaintiff "exhaust local remedies" in Japan before he could appeal to the United States (or a different contracting state) to submit the case to the International Court of Justice.[42] In Japan, where such a case would be one of first impression and where case law regarding judicial review of administrative actions is relatively undeveloped, exhaustion of local remedies could take several years, running up astronomical litigation costs. Moreover, as can be seen from the foregoing discussion, the statutory standards that would be applied in such a suit are sufficiently vague to allow a court to hold that official discretion had been exercised "reasonably" in many cases.[43] But most importantly, even if the plaintiff were to win the case and begin operations in Japan, it would not have gained much, for it would be starting out in the Japanese market with a firmly established reputation as an antagonistic, no-holds-barred competitor.

It should be noted that the "liberalization" policy of the FECL does not extend to grants of business licenses and approvals (*kyoninka*). Licenses are presently required in the insurance,[44] banking,[45] securities,[46] gas[47] and oil[48] industries, to name a few. Applications for such licenses must be made in addition to the filing of an establishment notification pursuant to the FECL. In the past, applications have been subject to intense scrutiny and granted only on a case-by-case basis, serving as an extremely effective mechanism for protecting domestic incumbents. Whereas Japanese companies are often able to hire retired bureaucrats as

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record stating that promotion of foreign direct investment is the best way to solve Japan's balance of trade dilemma. *See* Ike, *The Illusion of Japan as Invincible Economic Giant*, The Wall St. Journal 31, Sept. 21, 1981, at column 3. Public recognition of Japan's achievements is on the increase; witness the best-selling success of E. VOGEL, JAPAN AS NUMBER ONE (1979) in its Japanese translation.

40. Treaty of Friendship, Commerce and Navigation, April 2, 1953, U.S.-Japan, art. VII, XII, 4 U.S.T. 2063. *See also* HENDERSON, *supra* note 26, at 273-83.

41. Treaty of Commerce, Establishment and Navigation, Nov. 14, 1962, U.K.-Japan, art. 2(2); 13, 478 U.N.T.S. 6934.

42. *See* D. HENDERSON, *supra* note 26, at 286-87.

43. *Id.* at 287.

44. *Hokengyōhō* (Insurance Industry Law) art. 1 (Law No. 41 of 1939).

45. *Ginkōhō* (Banking Law) art. 2 (Law No. 21 of 1927).

46. *Shōken Torihikihō* (Securities Transactions Law) art. 28 (Law No. 25 of 1948).

47. *Gasu Jigyōhō* (Gas Industry Law) art. 3 (Law No. 51 of 1954).

48. *Sekiyūgyōhō* (Petroleum Industry Law) art. 4 (Law No. 128 of 1962).

directors and use their contacts in government to aid in obtaining approvals (the so-called "descent from heaven"), foreign companies are unable to use this tactic because of their foreign taint and generally low prestige.

2. *"Takeovers" and Other Acquisitions of Stock in Listed Corporations*. Under the old system, acquisitions by a single foreign investor of up to 10% of an existing company's stock were given "automatic validation" as long as the stock owned by all foreign investors in the aggregate would not thereby reach or exceed a level of 25% of issued stock.[49] Acquisitions beyond either of these limits were scrutinized on a "case-by-case" basis unless the target corporation consented to the acquisition. The preceding section has already shown how the FECL has incorporated the old 10% limit. Of course, if this were the only applicable rule, it could be easily evaded by a foreign investor who made his purchases in batches of less than 10%. What remains to be shown is how the drafters of the FECL have managed to reinstitute the essential constraints of the aggregate limit as well.

Under a "supplementary provision" to the FECL that states on its face that it is only effective "for the time being",[50] when the Minister of Finance and the Minister in charge of the industry involved deem it necessary, they may designate individual Japanese companies as "requiring an inquiry" as to whether either of the following consequences might ensue from the possession by foreign investors of more than a certain quantity of that company's stock:

(i) it might endanger the national security, hinder the maintenance of public order, or hamper the the protection of public safety;

(ii) it might have a significant adverse effect on the "smooth operation" of the Japanese economy.[51]

A Cabinet Order[52] set the "certain quantity" referred to here at 25%, but provided that the Ministers may raise this ratio as they see fit. Just before the FECL became effective, the government designated 11 companies under this rule and prescribed upper limits for each of them.[53] Since then, no designations have been

49. 15% in the case of certain "restricted" industries such as banks, electric utilities, gas utilities, transportation and broadcasting. *Gaishi ni kansuru Hōritsu no Kitei ni motozuku Ninka no Kijun no Tokureinado ni Kansuru Seirei* (Cabinet Order Concerning Special Orders for Validation Standards Based on the Foreign Investment Law) art. 4(2) (Cabinet Order No. 221 of 1962).

50. "*Tōbun no aida*".

51. FECL, *supra* note 4, supplementary provisions art. 2(1).

52. Direct Investment Cabinet Order, *supra* note 8, art. 7(4), (5).

53. The 11 companies and their respective upper limits are: Arabian Oil (25%); Shōwa Oil (50%); Mitsubishi Oil (50%); Tōa Fuel Industries (50%); Kōa Oil (50%);

made.

When a foreign investor wishes to acquire any number of shares of a listed corporation that has been designated, he must request advance confirmation from the Minister of Finance as to whether or not the acquisition will result in an aggregate foreign shareholding ratio which equals or exceeds the stated limit.[54] This request must be made through the Bank of Japan within 40 days prior to the proposed purchase.[55] The subsequent procedures are similar to those discussed in the preceding section. Within 40 days of the purchase, the investor must submit a notification setting forth the details of the transaction. There is a 30 day waiting period, which can be extended to 4 months. After hearing the opinion of the "Foreign Exchange Inquiry Council", the Ministers are authorized to issue "recommendations" and "orders" to modify or cancel the transaction.[56]

It is primarily this rule which has prompted certain observers to complain that the new FECL is little more than "window dressing".[57] This view is not an uncommon one even in Japan. One editorial minced no words, saying: "To label as 'liberalization' a system that allows officials of the Ministry of Finance and MITI to impose restrictions whenever they deem it necessary violates the definition of the word. If this can be called liberty, than absolutism and totalitarianism are liberty as well."[58] Other members of the press have been a bit less direct, but after the excitement preceding promulgation died down, the general assessment has been similar.[59] The supplementary provisions invite criticism because their ambiguity leaves so many questions unanswered. For instance, what specific standards should be applied in determining when the conditions for designation are met? What does "smooth

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General Oil (49%); Fuji Electric (26%); Hitachi (30%); Katakura Industries (25%); and Sankyō (25%). Joint Ministerial Notification No. 1 of Nov. 28, 1980, by the Ministries of Finance, Welfare, Agriculture, Forestry and Fisheries, and International Trade and Industry.

54. FECL, *supra* note 4, supplementary provisions art. 3(2); Direct Investment Cabinet Order, *supra* note 8, art. 8(5); *Hikyojūsha de aru Kojinnado ni yoru Kabushikitō no Shutoku no Kakunintō ni kansuru Shōrei* (Ministerial Ordinance Concerning Confirmations for Stock Acquisitions by Nonresidents) art. 1(1) (Ministerial Order No. 46 of 1980).

55. FECL, *supra* note 4, supplementary provisions art. 3, 4; Direct Investment Order, *supra* note 12, art. 4(1).

56. No separate notification is required where the purchase totals 10% or more of issued stock, because notification would be required anyway under the direct domestic investment rules.

57. BUS. WEEK, Dec. 8, 1980, at 95.

58. Editorial, *Shingaitamehō to "Nottori"* (The New Foreign Exchange Law and "Takeovers"), 894 SHŌJI HŌMU 100 (1981).

59. *See* Nihon Keizai Shinbun (Japan Economic Journal; hereinafter cited as "Nikkei Shinbun"), March 3, 1981, at 2. ("The new law allows 100% [ownership], but above all, this is just in principle.")

operation of the Japanese economy" mean? When should the upper limit be set higher than 25%? Should the Ministers consider the applicant's present shareholding ratio in deciding whether to cancel or modify? Should they consider the wishes of the management and shareholders of the target company? Where a target company is highly diversified, who is the "Minister in charge of the industry involved"? What happens when that Minister cannot agree with the Minister of Finance? Because the supplementary provisions leave the solution to all these problems at the discretion of the bureaucracy, the practical effect of "designating" a company—though it is merely a sublime form of administrative guidance—is to sharply warn foreign investors that further purchases will not be permitted. In this sense, the designation rule is much more far-reaching than the notification provisions, because it affects the acts of many investors over a long period of time, rather than only one investor at one point in time.

A recent court battle in Japan may shed some light on these questions. The case concerns Katakura Industries, Ltd., and a group of Hong Kong investors who are heavily involved in real estate and leasing operations.[60] Katakura was one of the firms to be designated by the government (i.e., as requiring an inquiry) just prior to the enforcement of the FECL.[61] At that time, holdings of the Hong Kong Group in Katakura stood at about 23.5% of issued stock,[62] and the government prescribed 25% as the level of foreign holdings that would spark an "inquiry". The designation was criticized not only by Wang and his associates but by Japanese public opinion as well.[63] Whereas all the other designated companies are involved in industries that arguably should or can be protected[64]—oil, nuclear power, aircraft instruments, narcotics and vaccines, and agriculture-fisheries—,Katakura is best known as a top-rate silk spinner but a lackluster textiles company overall. After the designation, the government tried to compose an argument that Katakura's business activities fell in the protected category of "agriculture"[65] because it held a 10% share of the raw silk processing market and a 13% (the leading) share in the "traditional" silkworm market,[66] but the strength of this defense was belied by the fact that only about 2% of Katakura's sales

60. Led by Wang Tseng Hsiang, the members of this group include Cheng Yu Tung, Newpis Hongkong Ltd., and B.B.L. Nominees, Ltd.

61. *See* note 53, *supra*.

62. JAPAN COMPANY HANDBOOK, 2ND HALF 1980, 180 (1981).

63. The Japan Economic Journal, Jan. 20, 1981, at 20, col. 4.

64. All of these except nuclear power are industries for which Japan has made reservations to the OECD Code of Liberalisation. *See* O.E.C.D., CODE OF LIBERALISATION OF CAPITAL MOVEMENTS 74 (1978).

65. *Id.*

66. Nikkei Shinbun, Feb. 24, 1981, at 3.

were comprised by the latter and 46% by the former.[67]

Then why was Katakura designated? Considerable lobbying had taken place behind the scenes. According to media reports, Katakura's management, fearing a takeover by the Hong Kong Group, had pleaded with the Ministry of Agriculture, Forestry and Fisheries to have the firm designated even though the Ministry of Finance was opposed to the idea.[68] Top management at Katakura had good reason to fear the worst from a takeover by the Hong Kong Group. Previously, when the company had presented its plans to build a shopping center on its land and lease the facility to Itōyōkadō, Wang Tseng Hsiang (the leader of the Group) had sued Katakura's president for violating his duty of loyalty as a director, saying that the site should be partitioned and developed as a condominium complex instead.[69] As if this were not enough, when Katakura sought the cooperation of Taisei Construction (one of its major shareholders) so as to help it increase its "floating shares" and thereby retain its status as a corporation listed on the Tokyo Stock Exchange, Wang appealed to the Tokyo Procurator's Office on grounds that this was a violation of the Securities Exchange Law.[70]

Taken by itself, this litigious approach[71] might have been enough to turn the government against the Hong Kong Group, but the inner politics were even more intricately woven in favor of designation. As will be explained in greater detail later, many corporations in Japan "belong" to one of the large financial-industrial combines, or *keiretsu*.[72] These corporate groups are composed of companies that are loosely bound together for their mutual benefit by cross-shareholding and lines of credit extended

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67. KAISHA YŌRAN (Company Survey) 247 (Oct., 1980). The remaining sales were made up by operations in knitting, processing, services, trading and other sectors.

68. Plaintiff's Brief No. 5, submitted during arguments for Case No. 20 of 1981, Tokyo District Court, 2nd Civil Affairs Division. For full case cite, *see* note 75 *supra*. The designation was ultimately made in a notification issued jointly by the Ministries of Finance, Agriculture, International Trade, and Welfare because, as the government later explained, "it would look better that way." Defendant's brief No. 3. *Id.* at 2.

69. Nikkei Shinbun, March 3, 1981, at 2.

70. *Id.* "Floating shares" is the number of a company's shares which are estimated to be held on a relatively short-term basis. The precise definition is complicated, but roughly speaking, it is the aggregate of shares owned by shareholders who individually own between 500 and 50,000 shares. The Tokyo, Osaka and Nagoya stock exchanges prescribe lower limits for floating shares; companies must exceed the limits or suffer delisting. *See* TOKYO STOCK EXCHANGE, JŌJŌ SHINSA KIJUN (Listing Screening Standards), attached list No. 3.

71. Japanese society in general displays a pronounced distaste for litigious in favor of consensus-seeking attitudes. *See* THE JAPANESE LEGAL SYSTEM 286-432 (H. Tanaka ed.1976). It is reported that Wang's tactics have alienated him in Japanese financial circles. Nikkei Shinbun, *supra* note 69, at 3.

72. *See* text accompanying notes 133 and 155-158 *supra*.

by member banks. Both Katakura and Taisei Construction are members of the Fuyō Group (the Fuji Bank *keiretsu*); one of Itōyōkadō's major shareholders is Mitsui Mutual Life; and Mitsui Bussan and Fuji Bank are the second and third largest shareholders of Katakura. Thus, Wang's proposals were unacceptable not only to Katakura's management, but to Katakura's other large shareholders and their *keiretsu* as well.[73]

On January 9, 1981, a member of the Hong Kong Group, Cheng Yu Tung, announced that he would notify the MOF that he planned to purchase 9.9% of Katakura's shares on the open market over a span of a year. This purchase would have raised the Group's holdings to a point near that of the combined holdings of the Fuyō and Mitsui Groups, in excess of either one, and it would have further endangered Katakura's "floating stock" ratio. The government refused to accept the notification on the grounds that the proposed time span for purchases was too long (violating the "within 40 days" rule), and the number of shares to be purchased was too great.[74]

On January 24th, the Hong Kong Group instituted suit in the Tokyo District Court in the name of Newpis Hongkong Ltd. against the Ministers of Finance, International Trade and Industry, Welfare, and Agriculture, asserting that their designation of Katakura was illegal and seeking its annulment and revocation.[75] The complaint began by discussing the express purposes of the FECL and the various international pressures that led to its enactment. It then asserted that the designation was illegal because the supplementary provisions[76] do not permit Ministers to consider

73. As of December, 1980, the combined shareholdings of affiliates of either the Mitsui or Fuyō Groups were 37.5% of Katakara's issued stock, JAPAN COMPANY HANDBOOK, 1ST HALF 1981 178 (1981). Among the *keiretsu*, the Fuyō Group is said to have particularly close ties with government. *See* HANDBOOK OF JAPANESE FINANCIAL/INDUSTRIAL COMBINES 44 (Pacific Basin Reports, 1972). Even if they had been indifferent to Wang's ideas, the other *keiretsu* firms would side with Katakura's management as a matter of standard business practice. *See* text accompanying note 158, *infra*.

74. Nikkei Shinbun, Jan. 12, 1981, at 1; Jan. 14, 1981, at 11. According to these newspaper reports, the Hong Kong Group had never expected approval and had submitted the notification merely to ascertain the government's position once and for all prior to filing suit.

75. *Id.*; Complaint, Gaikoku Kawase oyobi Gaikoku Bōeki Kanrihō Kokuji Shobun Torikeshi Seikyū Jiken (Action Seeking Annulment of Notification Issued under the FECL), Case No. 20 of 1981, Tokyo District Court, 2nd Civil Affairs Division; *reprinted in* 894 SHŌJI HŌMU 30. The plaintiff was not covered by the "most favored nation" clause of the U.K.-Japan Treaty of Commerce, Establishment and Navigation because Britain never extended it to residents of Hong Kong. *See* note 40 *supra*.

76. Strong words were used to describe the supplementary provisions: "There may be some persons who regard this fact as Japan's shrewd attempt to. . .mutilate what is claimed to be a new Act to liberalize direct inward investment. . . .Plaintiff

how a foreign shareholding ratio in excess of prescribed limits might affect particular corporations in the same industry or related to the target, but only permit an examination of possible effects on the overall national economy, security, public order or public safety.[77] The complaint stated that the designation was an "administrative disposition" (*gyōsei shobun*) and therefore reviewable, because the cumbersome procedural requirements which it imposed restricted the rights of nonresidents (a specific class) to acquire Katakura's stock.[78] Finally, the plaintiff claimed that it was not required to submit its grievance to an administrative inquiry because the very fact that the designation was made by top leadership in four different ministries was sufficient "just cause"[79] to believe that no relief would be forthcoming.[80]

As of this writing, the case is stalled over the reviewability question[81] and is not expected to proceed to the merits until some-

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hopes that this is not true. Should it be true, it would internationally mean that the new legislation was nothing but a mere trick. . . ." *Id.*, at 20-21.

77. Compare the standards for designation contained in the supplementary provisions, at text accompanying note 51 *supra*, with the standards for approval of branch and subsidiary investments, at text accompanying note 20 *supra*. The wording in the latter is identical to the former, except for the reference to particular enterprises. In the phrase "or impede", "or" has been translated from "*sonota*", which in a legal context cannot be interpreted to mean that the clause which follows is an example of the preceding clause. Moreover, since the FECL's promulgation Japan has stricken, from its list of reservations to the OECD Code of Liberalisation of Capital Movements, a reservation regarding investment in otherwise nonrestricted (existing) enterprises, *see* text accompanying note 32 *supra*, where the enterprise concerned does not approve of the investment. Letter from Yutaka Tokui, *supra* note 32.

78. The gist of this assertion was that if a foreign investor were to follow the letter of the law, it would have less than 10 days in which to purchase shares on the open market. This would occur because confirmation must be requested 40 days before the date of the transaction, and after receiving confirmation the investor must wait at least 30 days before consummating the deal. Furthermore, the FECL's regulations require the investor to identify the proposed seller in his notification. Under these conditions, the investor would be unable to purchase a significant amount of stock for a reasonable price, and would have no alternative but to send off multiple notifications in rapid-fire succession, once for each time he negotiated a future purchase. This, of course, would outrule open-market purchases.

79. *See Gyōsei Jiken Soshōhō* (Administrative Case Litigation Law) art. 8(2)(iii) (Law No. 139 of 1962).

80. Complaint, *supra* note 75.

81. To summarize the first five months of litigation, the government (counsel of 18 members) has asserted that: (a) the designation was not an "administrative disposition" but an act of administrative rulemaking (*hōki meirei no teiritsu kōi*) authorized by statutory delegation, (b) moreover, the designation cannot be characterized as an "administrative disposition" because it only erected a procedural requirement similar to others already in existence and imposed no substantive restrictions on the rights of specific persons, and (c) MITI and the Ministry of Welfare did not participate in making the designation; the "joint notification" format was chosen only because ". . .it would look better that way. . . ."

Counsel for the plaintiff (2 attorneys) has argued as follows: (a) "just cause" for immediate suit exists because, in view of the internal structure of the Japanese government, the result of an administrative inquiry would almost certainly be to deny

time in the beginning of 1982. What can be learned from the Katakura case? The main lessons can be articulated as follows:

(i) don't buck the consensus developed by other major shareholders, particularly those affiliated with *keiretsu*; seek to complement rather than conflict with them;

(ii) hostile takeovers are taboo; in fact, the main purpose of the supplementary provisions is to prevent them.[82] Wherever possible, foreign investors should take the time to search for targets that are "friendly" towards them; and

(iii) avoid a litigious attitude at all times; flexibility is the key.

The government is reported to have become more cautious about making designations since the Katakura suit began.[83] Appeals to their regulating ministries by Yamato Transport Co. and Yamanouchi Pharmaceutical Co. (foreign holdings, 22% and 27.5% respectively) for designations have been rejected. It is said that fear of a legal battle is one of the main reasons for the change in bureaucracy's attitude. Indeed, the MOF went so far as to send copies of the Katakura complaint to each of the 10 ministries and agencies that have jurisdiction over business enterprises.[84] This would appear to indicate that the MOF has accepted the complaint's argument that the supplementary provisions do not permit Ministers to consider effects on particular companies when making designations. Ironically, even if it succeeds in permanently changing the direct investment climate for other nonresidents, the Hong Kong group may very well turn out to be a loser in the end.

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relief; (b) joint notifications can only be issued when each of the issuing Ministers has jurisdiction over the subject in question and these jurisdictions overlap; (c) moreover, by listing two non-participating Ministers on the notification the public was deprived of a means to discover the designator(s) and the reasons for designation; (d) therefore, the notification was made by an illegal procedure; (e) the FECL contains no provisions delegating to the Ministers rulemaking or lawmaking powers with respect to designations; (f) "nonresident shareholders of Katakura Industries" is a specific class of individuals, whose ability to transfer Katakura stocks at a fair market price was restricted by the designation; (g) the rights of Katakura Industries itself were restricted, in that the company was deprived of a significant source of capital (foreign investors); (h) the wishes of Katakura's management should have been irrelevant to the designation decision; and (i) it would have been almost impossible to prosecute violators of an order not to purchase, in that they would probably reside abroad.

In August, the Court submitted two questions to an expert on administrative guidance matters, Professor Kazuo Yamanouchi (*see* note 27 *supra*). One of his replies, to the effect that designations under the FECL are immediately reviewable, should help the plaintiff's case. Briefs in the Katakura case, cited at note 75, *supra*.

82. One book on the FECL—authored by an official of the MOF—begins the section on the supplementary provisions with the title: "Restrictions on Takeovers". ATARASHII GAIKOKU KAWASE KANRIHŌ NO KAISETSU (Commentary on the New Foreign Exchange Control Law) 56 (H. Fukui ed. 1981).

83. Nikkei Shinbun, June 10, 1981, at 2.

84. *Id.*

Win or lose, the group has firmly established their image as litigious and argumentative, something that is certain to trouble them later on. Winning the suit would not give the group the power to take over management of Katakura; it would only mean that it would be free to acquire stock in successive batches of less than 10% of issued stock each. In desperation, Katakura and the other major shareholders might seek to reduce Katakura's "floating stock" enough to have the firm delisted. Should that occur, the group would again be faced with a notification requirement, only this time Ministers would not be prohibited from considering the effect on individual firms.

Clever investors might be tempted to evade the FECL's definition of "foreign investor"[85] by creating intermediary subsidiaries in Japan to purchase and hold stock in a target company. For instance, if a foreign company held 49% of the shares of two Japanese subsidiaries, each of which holds 49% of the shares of other, the foreign firm would be able to exercise sufficient control (assuming the other shares are dispersed or in friendly hands) to engineer acquisitions of Japanese companies without running afoul of the FECL. Though the 1981 amendments to the Commercial Code prohibit "subsidiaries" from owning stock in parent firms, neither subsidiary in this scheme would come within the ambit of this rule because the parent firm holds less than a 50% interest in the Japanese affiliates.[86] What would make the scheme fail is that the subsidiaries would be considered to be "holding companies", which are prohibited by Article 9 of the Antimonopoly Law.[87] Of course, nothing would prevent a group of foreign companies from banding together much as the *keiretsu* do—setting up cross-shareholdings in unprovocative percentages of 15-20% or so—in order to exert acquisitive power collectively.[88] Totally apart from acquisitions, grouping together like this would also bring the bene-

85. *See* text accompanying note 8, *supra*.

86. COMMERCIAL CODE, art. 211-2(1). *See* note 158, *infra*.

87. Antimonopoly Law, art. 9 (Law No. 54 of 1947). A "holding company" is defined as a company whose primary business is to dominate the business activities of another company by holding stock in that company. Under the FTC's current enforcement practices, the primary definitional line as to "primary business" is drawn where stockholdings in a subsidiary comprise 50% or more of a parent company's total assets, but other circumstances are considered as well. As for the definition of "dominate", this too depends on the totality of the circumstances, but violations have been found where holdings were as low as 25.5% of the subsidiary's issued stock. Joint ventures usually create no difficulties, either because the foreign partner is a foreign entity, or because the two roughly equal stockholdings are seen as cancelling each other out and precluding "domination". *See* Watanabe, *Gaikoku Kaisha ni yoru Nihon Kigyō no Kabushikishoyū to Dokusen Kinshihō* (The Antimonopoly Law and Possession of Stock in Japanese Enterprises by Foreign Companies) 719 SHŌJI HŌMU 21.

88. *See* note 158 and accompanying text *infra*.

fits of mutual services, communication, and general support. It would require some long-range planning, but by now foreign companies must be willing to admit that the Japanese market is worth a little extra effort.

II. THE BUSINESS ENVIRONMENT FOR BRANCHES AND SUBSIDIARIES

At first glance, a branch or subsidiary—being wholly owned—might seem to be the ideal vehicle for conducting business in Japan, but in practice this is not always so. It is true that branch or subsidiary forms of organization afford a foreign company the advantages of full control and planned market entry, and in the early stages of entry strategy they serve perfectly well as centers for information-gathering. However, the numerous disadvantages of being a total newcomer to the Japanese scene may outweigh these positive features.

A. The Importance of a Network

A recurring theme in this section and the sections that follow is the special value that an extensive network of business contacts, customers and suppliers confers in Japan. One of the most fundamental rules of strategy followed by Japanese companies is that long-term business relationships should be maintained even at the expense of short-term profit opportunities.[89] Obeying this simple principle, customer suppliers, banks and even the government all tend to favor those businesses that have been able to establish a strong reputation for permanence and trustworthiness. Once acquired, such a reputation and the web or relations that accompanies it become the key to financial success. However, long-term relationships being what they are, it may take years to build up these intangibles. Compared with a joint venture or an acquired company, a branch or subsidiary is at a clear disadvantage in this regard.

B. Manufacturing

The lack of an existing network of business contacts can pose serious problems for the manufacturing operations of a newly established branch or subsidiary. Unless it plans to ship raw materials and parts to Japan for processing or assembly, the foreign investor must find local suppliers.[90] Because inventory carrying

89. Part of the reasoning behind this unwritten rule is that long-term profits are the only kind that really count, and part is that relationships based on mutual trust enable interdependent firms to "stand together" during a slump and possibly extract benefits from one another. *See* R. CLARK, THE JAPANESE COMPANY 87-97 (1979).

90. In general, foreign companies are advised to thoroughly research the field for

costs are high in Japan, it would be best if these suppliers or subcontractors were located in the immediate vicinity of the new plant, so as to enable them to make deliveries on short notice.[91] Geographic proximity will also allow frequent consultations concerning production adjustments and credit terms. Furthermore, it would be ideal if the suppliers or subcontractors were dependent on the new plant, either because of long-term contracts with the plant,[92] the need to diversify, or the absence of enough current orders to run at full capacity.

From the new plant's perspective, the main difficulty with these objectives is that they are not feasible until it has forged a relationship of mutual trust with the suppliers and possibly even their close affiliates. This is a lengthy process, and it may well be aggravated by the new factory's inability to attract skillful executives who are trusted and respected locally.

C. Distribution

Similarly, without a network, a new enterprise may be deprived of an adequate distribution system. Although distribution channels vary immensely depending on the industry, product type, and retail outlet, as a general proposition they involve many more layers of wholesalers than are utilized in other countries. Usually, each intermediary finances the intermediary customers beneath it by accepting payment in the form of promissory notes which are due in 60 to 100 days or even longer.[93] Close financial relations between intermediaries and their customers are complemented by social ties. The wholesaler expects and gets a modicum of brand loyalty from his retailers. Because space is at a premium, the overall emphasis is on compensating for low inventories by

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suppliers and subcontractors in Japan. Extensive use of inexpensive, high quality subcontractors is one of the main ingredients in the success of many Japanese corporations. For example, in a big automobile firm like Nissan, only about 30% of the cost of goods and services used in the production of an economy car is represented by plant operations; the other 70% is taken up by orders to subcontractors. For textile machinery, the proportion of subcontracted costs is as high as 90%. *Id.* at 68.

91. This is a common method for minimizing stocking costs. Recently, much attention has been drawn to Toyota's "just-in-time" inventory system, which is just a systematic form of this practice.

92. Negotiation of a needs-supply contract may be difficult, given the typical Japanese executive's aversion to written contracts. The insertion of a clause in a technology licensing contract with a subcontractor that binds the latter to sell only to the foreign-controlled plant would violate the antitrust laws. Antimonopoly Law, art. 6(2), 19; *Kokusaiteki Gijutsu Dōnyukeiyaku ni kansuru Nintei Kijun* (Standards for Approving International Technology Induction Contracts) art. 1(5) (1968); *Fukōseina Torihiki Hōhō* (Unfair Business Practices) art. 1 (Fair Trade Commission Notification No. 11 of 1953).

93. BUSINESS STRATEGIES FOR JAPAN (J. Abbeglen, ed.) 140 (1970).

moving many *small* orders *frequently*.[94] The large number of competing manufacturers, wide variety of merchandise lines, and small size of most retail establishments combine to provide intensive coverage for many products.

Thus, retail markets in Japan are highly competitive, to a degree that might be considered "saturated" elsewhere. Given this structure, direct distribution is usually very costly, because it would involve (a) efficiently coordinating a virtual infinity of small orders, (b) evaluating the credit worthiness of numerous retailers, in a country where good credit ratings are scarce, and (c) bearing the heavy interest costs of extending credit to those retailers in an amount sufficient to draw them away from their comfortable ties with established distributors. In many cases, the new entrant will be unable to effectively break into the traditional distribution system, because loyalties remain strong even at the producer-wholesaler level. Here, it would be advisable for the new enterprise to plug into the distribution structure and introductions offered by a trading company, department store, or supermarket chain.[95] For products that cannot be sold through such channels, the foreign investor should investigate the opportunities for utilizing a Japanese company's existing network by means of a joint venture or acquisition.

This is not to suggest that all direct distribution efforts will be in vain. Quite a few foreign firms have managed to capitalize on market trends by modifying or completely avoiding the existing channels. For example, Nestlé has made great strides by using trading companies as order takers while it handles physical deliveries and sales promotions by itself;[96] and Coca-Cola has succeeded magnificently by pioneering a "route sales" system that employs carefully trained salesmen to make direct deliveries by truck.[97] Then again, for industrial and technical markets the rules of the game are completely different, and require extensive research and constant updating.

D. Recruiting Employees

After establishment, a branch or subsidiary will find itself sorely in need of a "web of relations" when it goes about staffing its operation. Although debate continues as to whether "lifetime employment" is more important as a reality or as a norm,[98] it is

94. *Id.* at 157.

95. *Id.* at 140.

96. Ninomiya, *Foreign Firms' Strategies for Japan: Case Studies of Nestlé and Coca-Cola*, THE ORIENTAL ECONOMIST 16 (Nov., 1980).

97. *Id.* at 20. Coca-Cola also pioneered the widespread use of vending machines in Japan.

98. R. CLARK, *supra* note 89, at 140, 174.

certain that the mobility of top-flight executives and technicians is rather limited in Japan. The new organization will be handicapped in its searches not only because it lacks a "university clique" and other sources for personal introductions, but also because it may be a non-entity in the public mind, a small foreign outpost with an uncertain future.[99] In recent years there has been an increase in the number of Japanese graduates of foreign business schools who are looking for work at foreign-affiliated firms, but demand still seems to outstrip supply.

E. Financing

Under the FECL, as long as the loan is not guaranteed by the home office or parent company, branches and subsidiaries are free to borrow on the Japanese market without being required to comply with any regulations over and above those governing normal lending transactions. If the home office or parent corporation guarantees the loan, the transaction will be classified as an unrestricted "capital transaction", but it can be made subject to a license requirement if the Minister of Finance deems that necessary in order to (a) maintain equilibrium in Japan's international balance of payments, (b) prevent a drastic fluctuation of the yen exchange rate, or (c) protect Japan's money or capital markets from the adverse effects of large fund transfers between Japan and other nations.[100] This contingency provision is often referred to as the "emergency situations clause" (or a similar title).

In addition, a branch or subsidiary can follow the example of most Japanese companies and obtain direct or indirect financing from affiliates or other domestic companies with which it has close ties. Such financing can take the form of a loan, or, where the other firm is a dependent supplier, the foreign-controlled enterprise may be able to extract more favorable trade credit terms from the supplier than it grants to its customers.[101] Another possibility is that the branch or subsidiary may be able to conclude service contracts with its parent office or Japanese companies with which it does business. In either case, the "financing" so obtained

99. Abegglen, ed., *supra* note 93, at 168, 170.

100. FECL, *supra* note 4, art. 20(2), 21(2).

101. The extensive use of such trade credit as a source of financing is both a function and a cause of continuing dualism (or "gradation") of the Japanese economy. In times of recession, extractions of extra credit echo down the hierarchy from large principal contractor to subcontractor to subordinate subcontractor. At each step of the way, credit and price terms become increasingly harsh,forcing many subcontractors to go bankrupt. The adverse effects are made worse by the highly leveraged nature of most Japanese companies. Thus, the best time to seek to acquire a supplier firm (or its assets) is during recessions. *See* text accompanying note 160 *infra; see also* R. CLARK, *supra* note 89, at 68-71.

will be free of governmental regulation.[102]

However, several factors may limit the availability of financing through domestic loans or favorable accounts receivables turnover. Commercial loans will usually be difficult to obtain at the outset of operations because many branches or subsidiaries will not have sufficient assets to secure a substantial loan. Even if a bank or related company extends a loan, the effective interest rate may be somewhat higher than the rate commanded by larger Japanese companies, reflecting the lender's concern with the small size and unknown reputation of the borrower.[103] Likewise, the foreign newcomer is much more likely to find itself at the bottom of a receivables totem pole than at the top, unless it has managed to locate suppliers and customers that depend on it for their existence.[104]

If domestic forms of financing are inadequate, the new enterprise can turn to foreign sources of funds. For branch offices, there is a license requirement for loans made by foreign corporations or banks to their branches in Japan[105] and for fund transfers or settlements which are accomplished by debiting and crediting an account.[106] Fortunately, however, the FECL has eliminated all restrictions on remittances for expenses of ongoing operations made by a foreign company to any of its branches in Japan.[107]

For subsidiaries, the general rule is that a loan by an individual or corporate non-resident to a subsidiary in Japan (a) in excess of ¥100 million for a term of more than five years, or (b) in excess of ¥2 billion for a term greater than one year but not exceeding five years, is classified as "direct domestic investment", subject to the prior notification requirements.[108] However, as mentioned earlier, the FECL exempts from this rule (a) loans made by a bank or other money-lending organization, and (b) yen loans made by a juridical person which would be deemed to be a "foreign investor" either because of the makeup of its board of directors or because its ratio of foreign source equity cap-

102. *Gaikoku Kawase Kanrirei* (Foreign Exchange Control Order) art. 9 (Cabinet Order No. 260 of 1980).

103. Banks tend to favor large businesses over smaller ones, not only by offering lower interest rates but also by requiring smaller compensating balances. *See* R. CLARK, *supra* note 89, at 62.

104. This point underscores the wisdom of negotiating with principal suppliers *before* committing resources to the Japanese market.

105. FECL, *supra* note 4, art. 22(1)(i).

106. *Id.* art. 17; Foreign Exchange Control Order, *supra* note 102, art. 7(1)(i).

107. FECL, *supra* note 4, art. 20(9); Foreign Exchange Control Order, *supra* note 102, art. 9.

108. FECL, *supra* note 4, art. 26(2)(vi); Direct Investment Order, *supra* note 12, art. 2(1). *See* the text accompanying note 12. At the present exchange rate of roughly ¥230 to the dollar, these amounts are $434,780 and $8,695,650, respectively.

ital.[109] The net result is that loans from parent companies to their subsidiaries in Japan have been freed of all restrictions so long as the loans are made in yen. The same applies to loans from affiliates in Japan to the Japanese subsidiary.

In sum, in their initial stages branches and subsidiaries may not fare so well on the domestic money and capital markets, but they should have little trouble acquiring funds from abroad. Where financing is needed for the expansion of facilities rather than for ongoing operations, branches (but not subsidiaries) may experience the slight delays posed by the notice requirement. In most situations, the overall financing picture will raise no insurmountable difficulties, but may confound an entry strategy based on taking full advantage of low interest rates in Japan.

F. Corporate Administration

Because of the relatively greater trust and respect that Japanese businessmen accord to stock companies (*kabushiki kaisha*) as opposed to branches and other forms of association,[110] foreign investors will usually prefer a subsidiary over a branch as an entry vehicle whenever operations are likely to expand rapidly. However, in deciding between the different forms of organization, investors should also take note of the fact that the Japanese Commercial Code does not authorize stock companies to use certain techniques for simplifying corporate administration which are available to corporations domiciled elsewhere. Attendance at board of directors meetings by proxy is not permitted, and the directors may not hold meetings by means of written consents or questionaires.[111]

These rules create an inconvenience for a parent company that wants close control over its subsidiary but cannot afford to send three representatives (the minimum number of directors)[112] to Japan to serve on the board. Though there are no direct prohibitions against convening the board abroad, in practice it is essential to have a quorum of directors present in Japan because the directors of a Japanese company actually manage its affairs. The legal representative of a Japanese stock company is its "representative director," appointed by the board of directors from

109. FECL, *supra* note 4, art. 26(2)(vi). *See* the text accompanying notes 7 and 8.

110. Limited companies (*yūgengaisha*), partnerships (*gōmei* or *gōshi gaisha*) and branches have a diminutive connotation in business circles. *See* D. HENDERSON, *supra* note 26, at 298.

111. COMMERCIAL CODE, art. 260-2(1); 2 T. ISHII, KAISHA HŌ 325 (Shōhō series, 1967). Telephonic meetings might be permissible, but this is an expensive way to hold meetings if the directors are in different countries.

112. COMMERCIAL CODE, art. 255.

among its members.[113] He must be available to sign major contracts and respond to official requests for action.[114] By one academic interpretation, because the representative director's main duty is to execute policy decisions made by the Board, he needs to be able to call meetings at short notice in order to draw authority from that body.[115] For all practical purposes, the 1981 amendments to the Commercial Code have codified this interpretation by prohibiting the board from delegating many decisions to any of the directors.[116] Whereas in a U.S. corporation it would usually be possible to delegate authority for major decisions to the officers of the company, the Japanese Commercial Code has no provisions permitting delegations to officers and fails to even recognize their existence except to state that such persons can bind the corporation by their apparent authority.[117]

G. Technology and Other Factors

One of the chief advantages of branches and subsidiaries is that they permit foreign firms to exercise tight control over their technology. Over the past few years, as large Japanese firms have become net sellers of technology,[118] more and more high-technology firms from Europe and the U.S. have taken to avoiding outright technology transfers in favor of establishing joint ventures, branches or subsidiaries in Japan.[119] As long as the Japanese FTC continues to police international licensing contracts by ordering deletion of price and territory restrictions, few technology-based firms will be able to afford the luxury of arming a

113. *Id.* art. 261. The board can elect more than one representative director if it wishes.

114. In addition, the president, vice president, executive director (*senmu torishimariyaku*) and managing director (*jōmu torishimariyaku*) can bind the company by their apparent authority. *See* note 116, *infra*. They will be considered to have adequate status to sign routine contracts, but this is largely because the president and vice president are usually its representative directors or at least are on the board. In contrast, though he is deemed to have apparent authority, a general manager (*sō shihainin*) will not be looked upon with favor by some parties. The general manager may have to present a power of attorney or other proof of his authority. Thus, practicality demands stationing the representative director and at least one other director in Japan. *Id.*

115. *See* T. ISHII, *supra* note 111, at 311.

116. Article 260-1 of the Commercial Code now requires the board to meet and vote on transactions involving important assets; large loans; hiring and dismissal of managers; establishment, liquidation and change of purpose of branches or other entities; and anything else of equivalent significance.

117. COMMERCIAL CODE, art. 262.

118. The Japan Economic Journal, June 16, 1981, at 1, column 4.

119. *Id.*, Sept. 23, 1980, at 11, column 1; The Wall Street Journal, Sept. 8, 1981, at 27, column 1.

competitor with a valuable license.[120] Accentuating the trend towards branches and subsidiaries is a growing recognition of the dangers of creating a "funnel" joint venture, i.e. a firm that merely siphons off knowhow, technology and profits to the Japanese partner and then withers away.[121]

In order to conclude international contracts for the transfer of rights concerning patents, designs, trademarks, utility models or knowhow, the FECL requires branches and subsidiaries of foreign corporations to give advance notice to the Minister of Finance and the Minister of the industry involved.[122] As with direct investments, there is a waiting period of 30 days during which the Ministers may "recommend" modification of the terms.[123] Happily, a Ministerial Ordinance[124] has eliminated the waiting period for nonstrategic technologies and small-sum contracts, so that the parties can often conclude agreements on the same day as they submit the notification.

It is important to remember that even under the FECL one of the parties (usually the Japanese one) still must allow the FTC to review international technology agreements between subsidiary and parent corporations.[125] However, the crucial difference between these contracts and agreements with a joint venture or straight licensee is that the licensor has internal control (as sole or majority shareholder) over the end-use of the transferred rights. There is no danger that secrets will be siphoned away. In reality, the contract terms are often mere formalities that are used to please the FTC.

Lastly, it should be noted that there are no regulations in the FECL governing acquisitions of interests in real property by subsidiaries. Acquisitions of real property by foreign companies for use by their branches are not subject to the standard notification requirement,[126] because the initial investment normally will have

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120. *See* Standards for Approving International Technology Induction Contracts, note 92 *supra*.

121. *See* J. Abegglen, *supra* note 93, at 99, 100. The Japanese partner can use transfer pricing to siphon off profits if it is a manufacturer of parts for the joint venture company.

122. FECL, *supra* note 4, art. 29(1). However, there are no restrictions on technology developed by the branch or subsidiary. *Id.*, art. 29(2).

123. FECL, art. 29(3), 30.

124. Direct Investment Order, *supra* note 12, art. 6(2). Where the consideration is ¥100 million (about $435,000 at ¥230 = $1) or less, the same-day go-ahead applies. The list of "provocative" technologies is contained in Ministerial Notification No. 3 of Nov. 20, 1980. It includes weapons, aerospace, computer, and leather technologies.

125. Antimonopoly Law, *supra* note 87, art. 6(2). Contracts between branches and their home offices are not subject to this requirement. *See* K. KAWAI, KOKUSAITEKI KEIYAKU TO DOKUSEN KINSHIHŌ (International Contracts and the Antimonopoly Law) 174 (1978).

126. FECL, *supra* note 4, art. 20(8).

already been approved as direct domestic investment.[127]

III. THE BUSINESS ENVIRONMENT FOR JOINT VENTURES

Joint ventures offer a number of advantages to foreign corporations. Mainly, by organizing a joint venture company with the right Japanese partner, a foreign investor is able to immediately plug into an existing network of contacts—in Asia as well as Japan—among suppliers, distributors, banks and government. Joint ventures are the form of direct investment most favored by the Japanese government.[128] For a foreign firm that is looking for a steady source of components and the possibility of soon showing profits from its Japanese operations, these advantages are tempting indeed. Of course, joint ventures have their weak points, too. Personnel problems may plague the new company.[129] Worse, the foreign partner may find that its technology has been siphoned away during the shuffle. Since most of these pros and cons have been covered in the previous section, it is not necessary to address them again here. Instead, this section is devoted to issues that are unique to the joint venture decision.

Undoubtedly, choosing the right partner is the most important decision the foreign company will make in establishing its joint venture. The foreign company is usually at some disadvantage in this regard. Most relationships between Japanese and foreign firms are initiated by the Japanese side, which is well informed on business affairs in the West and has spent considerable time researching the field. In contrast, the foreign company usually lacks a staff with the requisite linguistic and evaluative skills to gather detailed intelligence regarding Japanese firms.[130]

Establishing a relationship of trust and understanding with the Japanese partner is vital to the success of the joint venture. It

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127. *See* text accompanying note 11 *supra*.

128. At one point, the government even seemed to be proposing the 50-50 joint venture as an international standard for direct investment. *See* D. HENDERSON, *supra* note 26, at 241.

129. Since a joint venture is technically a subsidiary of the Japanese partner, it may suffer from the reputation of subservience and impermanence that that term (*kogaisha*) can connote. Transferees from the Japanese parent may believe they are being demoted, and in any case, the Japanese partner will usually try to keep the pay scale of the joint venture lower than or equal to its own pay level. Because they all stand to fare differently if the venture fails, transferees, new hires, and expatriate employees may factionalize. *See* R. BALLON & E. LEE, ed., FOREIGN INVESTMENT AND JAPAN 42-55 (1972).

130. Japanese firms are quite secretive with regard to management data, and they usually employ their own staff rather than public accountancy firms for managerial accounting purposes. Here again, the information that can be gathered in the absence of a network of relationships may be of limited value. *See* J. Abbeglen, ed., *supra* note 93, at 105.

is essential that each partner fully understand the other's motives for participating in the venture and that these aims be compatible over the long run.[131] The foreign partner should also attempt to assess the Japanese partner's "hidden assets and commitments" within its "web of relations".[132] Many firms in Japan are members of industrial groups that are commonly known as *keiretsu*.[133] Some *keiretsu* are organized around the trading firms that controlled the pre-war zaibatsu, some are organized around large banks, and still others are formed around major manufacturing companies. Usually, there is some degree of interlocking shareholding among member firms, and members tend to cooperate with other members so as to compete as a unit against outside firms.[134] Because these groups can be rather tightly knit, it is essential to understand the role banks, trading firms, and other affiliated companies play in the prospective partner's decision-making. The outside influences can be both positive and negative. The member trading firm might commit the partner to undesirable distribution channels, while the bank extends inexpensive loans. One observer has commented:

> The real strength of a Japanese company can be accurately gauged only in the light of its affiliations. By Western criteria, a given Japanese company may seem in shaky financial condition; but if a major Japanese bank—say the Sumitomo or Mitsubishi Bank—stands squarely behind it, the company is in

131. *See* R. BALLON & E. LEE, ed., *supra* note 129 *supra*, at 36. For instance, VW and Nissan recently announced creation of a joint venture to produce VW's "Santana" cars in Japan and sell them in Japan and other markets. One-fifth of initial output is sleighted for distribution to Asian countries, where VW wishes to "gain a foothold and show a flag". But if the current world-wide tide of protectionism halts its advance, Nissan's strategy objectives may shift away from cooperation with foreign makers. If Nissan has by that time already satisfied its primary goals of assimilating VW's diesel and alcohol engine technologies, one wonders how enthusiastic it would be about promoting the Santana automobiles—sold under the VW label—on its own turf in Asia. *See* The Wall Street Journal, Sept. 16, 1981, at 27, 30 col. 1; Ishizuke, *Nissan Motor Will Build Volkswagon Cars In Japan*, The Japan Economic Journal, Dec. 9, 1980, at 1, column 3.

One writer has commented ". . .it is the Japanese company seeking diversification and not now in the product area under discussion that has the most to gain from the aggressive growth of a new venture. It would also be a cooperative venture partner since it would be dependent on the foreign firm for the full range of skills in production, technology, and marketing." J. Abegglen, ed., *supra* note 93, at 108.

132. *Id.* at 105-07.

133. The six major *keiretsu* are: Mitsui Group, Mitsubishi Group, Sumitomo Group (these are the old *Zaibatsu*), Fuyō Group (affiliated with Fuji Bank), Dai-ichi Kangyo Group, and Sanwa Group. *See* Kōsei Torihiki Iinkai (Fair Trade Commission), KIGYŌ SHŪDAN NO JITTAI NI TSUITE (The Status of Enterprise Groups) (1979). There are also seven *keiretsu* organized around large manufacturers (and one railroad): the Nippon Steel, Tōshiba, Hitachi, Toyota, Nissan, Matsushita, and Tōkyū groups. *See* HANDBOOK OF JAPANESE FINANCIAL/INDUSTRIAL COMBINES, at note 73 *infra*.

134. *See* J. Abegglen, ed., *supra* note 93, at 106.

better financial shape than its balance sheet would suggest. Conversely, a company that might seem a promising partner for a joint venture may in fact be unattractive because its other commitments close a good part of the market to its products.[135]

A. Corporate Control Devices

Having finally selected a suitable Japanese partner, the foreign company will understandably wish to guarantee that the joint venture will be owned solely by itself and its partner. In this area of law, Japanese corporate practice has not evolved to anything near the level of sophistication that prevails in the United States.[136] Still, there are a number of techniques that may be employed to insure the stability of holdings in the venture company.

1. *Provisions Inserted in the Articles of Incorporation*. The partners will want to start out by providing in the articles for preemptive rights and cumulative voting for directors. Additionally, Article 204 of the Commercial Code permits incorporators to include in the articles a provision requiring board approval for all share transfers. When such a provision exists and the board has refused to approve a proposed transfer, the Code requires the board of directors to suggest an alternative purchaser for the offered shares within two weeks of its invalidating decision.[137] The alternative purchaser can then demand that the shareholder sell the stock to it within ten days.[138] Of course, there is nothing to prevent the board from designating the foreign venturer—or a supplier it patronizes—as the alternative buyer.[139] If the parties cannot agree on a price, the matter can be submitted to a court of law, which will set a fair price for the shares.[140]

As a further precaution, the joint venturers can insert in the articles provisions for higher voting and quorum requirements for shareholder and board decisions than is required by law.[141] Because the Commercial Code already provides for extra stringent voting requirements (a two-thirds vote out of a quorum of one-half) for shareholder resolutions regarding certain fundamental

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135. *Id.* at 108.

136. For instance, corporate by-laws are virtually nonexistent. The interlocking business relationships of many Japanese firms mean that corporate control devices are usually unnecessary.

137. COMMERCIAL CODE, art. 204-2(2).

138. *Id.* art. 204-3(1).

139. Of course, if the foreign joint venturer is designated, the purchase would be treated as "direct domestic investment" under the FECL.

140. *Id.* art. 204-5.

141. *See* Swisher, *Use of Shareholder Agreements and Other Control Techniques in Japanese Joint Venture Corporations and their Validity under Japanese Corporate Law*, 9 INT. LAW. 169 (1978).

acts,[142] this device may not be necessary as long as the articles explicitly provide for preemptive rights.

Though it is rarely done, it is also possible to achieve restrictions by creating multiple classes of shares in the articles, each class having different voting rights.[143] The articles can establish a non-voting class of shares, so long as they do not exceed 25% of the company's issued stock.[144]

2. *Restrictions Contained in the Joint Venture Agreement.* Jurists in Japan are virtually unanimous in agreeing that contract limitations on share transfers not conforming with Article 204 of the Commercial Code will be binding on the parties to the agreement.[145] Here, the only problem is that a third-party transferee will not be covered by the agreement's restrictions, regardless of whether he takes with notice or not.[146] Voting trusts and shareholder agreements to restrict votes would probably also be viewed as valid, but suffer from the same defect. To guard against the near certainty that damages from a violative transfer will be very difficult to prove in court, joint venturers are advised to insert a reasonable liquidated damages clause in the joint venture contract.[147]

IV. THE BUSINESS ENVIRONMENT FOR CORPORATE ACQUISITIONS

By now, the merits of acquiring an existing corporation over establishing a new operation must be quite clear: a ready-made reputation and network; convenience in relations with banks, suppliers and government; and easy availability of qualified employees. The problem with acquisitions in Japan is that receptive target companies are rare, and hostile takeovers are nearly impossible. One of the odd things about the FECL's supplementary provisions is that in the great majority of cases they are unnecessary. There are already so many natural barriers to takeovers that legal restrictions are hardly needed. This section is devoted to the practicalities of identifying and seizing opportunities for the acquisition of a Japanese company.

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142. COMMERCIAL CODE, art. 343. Such acts would include amendment of the articles and acts having equivalent effect. T. ISHII, *supra* note 111, at 267-269. *See* notes 148-51 *infra*.

143. *See* Swisher, Use of Shareholder Agreements, *supra* note 141, at 170. *See* notes 149-151 *infra* and accompanying text.

144. COMMERCIAL CODE, art. 242(2).

145. *See* D. HENDERSON, *supra* note 26, at 300.

146. *Use of Shareholder Agreements, supra* note 141, at 164-165. *But see* D. HENDERSON, *supra* note 26, at 306.

147. *See* D. HENDERSON, *supra* note 26, at 301.

A. Non-Legal Factors Making Acquisitions a Rare Phenomenon

1. *Reaction of Management*. As a matter of law, a Japanese corporation is owned by its shareholders and operated by its management. The shareholders elect directors[148] and must vote on certain matters which affect the fundamental structure of the corporation: amendment of the charter,[149] mergers,[150] assignment of enterprise,[151] and the like. However, in practice the members of the board of directors are hand-picked by the representative director from the body of corporate employees and therefore are very loyal to him. These appointments are almost always ratified by the shareholders, who exercise little actual control over management and in essence are viewed by management as just another form of lender.[152]

Thus, for all practical purposes, management "owns" the corporation and can be expected to vigorously oppose any acquisition, if for no other reason than that it fears disruption of its closely-knit board by foreign directors. Management can rally strong allies to assist it. Not only will the company's entire network of contacts (who are often its major shareholders as well) be on its side, but the general public hostility to takeovers will help it mobilize support in government and financial circles.[153]

Still, there are certain cases where management may be indifferent to or even welcome stock acquisitions by foreign interests.

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148. COMMERCIAL CODE, art. 254.

149. *Id.* arts. 342, 343. A quorum is one half of issued shares; a two-thirds vote is required.

150. *Id.* arts. 343, 408 (Two-thirds vote).

151. *Id.* arts. 245(1)(i), 343 (Two-thirds vote).

152. *See* the text accompanying note 136 *supra*. In addition to the high level of corporate and institutional stockholdings, *see* notes 156, 165 and accompanying text *infra*, one of the reasons for the diminutive treatment of stockholders is the prevalence of the *sōkaiya*, "general-meeting mongers" who hold one or two shares and can be hired to discourage other shareholders from attending meetings and making proposals. The *sōkaiya* will often demand that management pay them to keep them from attending meetings and causing trouble where none was expected. The 1981 Commercial Code amendments included several changes that are intended to curtail the use of *sōkaiya* and the influence of management on stockholder meetings in general (i.e., raising the minimum par value from ¥50 to ¥50,000; fortification of reporting and procedural requirements). *See* Inaba, *Shōhōnado no Ichibu o Kaisei suru Hōritsu no Gaiyō* (Summary of the Law Amending the Commercial Code) 909 SHŌJI HŌMU 2.

153. The Japanese word for "takeover" (*nottori*) carries negative connotations, suggesting a speculative group of opportunists who are willing to ignore normal business channels in their desire for power and quick profits. Even though they have not actually "taken over" other firms, investor groups such as the "Seibi group" or the "jūzenkai" have created considerable commotion by playing the market and upsetting the status quo. *See* Kamizaki, *Tōshi Kōmon no Kisei*, (Restrictions on Investment Advice) 904 SHŌJI HŌMU 2.

A firm that is faced with a choice between being acquired and liquidating would almost certainly prefer to be acquired. Likewise, a company that is in danger of being taken over by Japanese interests might welcome an acquisition by a foreign firm because there is a greater chance that the foreign investors will retain management "as is" and avoid putting the subsidiary in an overly subordinate role. Lastly, companies that are heavily dependent on foreign sales or technology may welcome foreign stockholders as a means to improve visibility, sales, and contacts overseas.[154]

2. *Cross-Shareholding*. As noted earlier, many corporations in Japan "belong" to one of the six large corporate groups (the *keiretsu*).[155] One of the principal ties binding each *keiretsu* together is the extensive cross-shareholding between its members.[156] In addition, most sizable Japanese corporations enter into an affiliation system of vertical relationships with their suppliers and major outlets, also based on cross-shareholding.[157] As a result, it is not unusual in Japan that the target corporation is a substantial shareholder of a substantial shareholder of itself. Under such circumstances, the representative director of each company will vote his corporation's shares in the other in accordance with the wishes of the other company's management, expecting the same favor in return.[158]

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154. Companies like Sony and Hitachi are examples of the latter. Sony's managing director is on record as saying that Sony feels foreign holdings of about 30% are "about ideal". Round Table Discussion, *supra* note 2, at 13. A poll of Japanese companies showed that the ratio of "welcoming" firms was high in the electric, machinery, real estate, land transport, and retail industries. The Japan Economic Journal, Dec. 23, 1980, at 3. Most of these companies are primarily interested in small individual shareholders overseas, but this would not preclude receptiveness to a large acquisition if the foreign acquirer had something to offer in return.

155. *See* note 133 *supra* for the names of the *keiretsu*.

156. In 1970 the average cross-shareholding ratio among firms in the six *keiretsu* ranged from a high of 20.11% (Sumitomo) to a low of 11.16% (Sanwa). All figures were on the increase as compared to a decade before. SENGO NIHON NO KIGYŌ SHŪDAN (Enterprise Groups in Post-War Japan) 30 (M. Yoshikazu, ed. 1978). In view of the upper limit on holdings by financial institutions, *see* note 161, *infra*, these holdings ratios are significant.

157. *See* R. CLARK, *supra* note 89, at 85-91.

158. Where the favor would be directly returned, this is known as the "hollowing" of capital. Treasury shares are generally forbidden in Japan, COMMERCIAL CODE, art. 210, but this is one way the prohibition can be avoided. The 1981 amendments to the Commercial Code attempt to reduce "hollowing" by forbidding a company from exercising voting rights with respect to shares it holds in another company if that other company owns more than 25% of the first company's stock. COMMERCIAL CODE, art. 241(3). Moreover, the amendments prohibit a subsidiary from owning stock in its parent (the latter being defined as a company owning more than 50% of the subsidiary's stock). COMMERCIAL CODE, art. 211-2. Of course, the new rules do nothing to prevent the kind of widely-dispersed cross-shareholding (where firms only hold about 15% or so of each others' stock) that is much more prominent in Japan.

3. *Debt-Equity Ratios*. In Japan, the debt-equity ratio[159] of the average manufacturing corporation is about 80:20, whereas in the U.S. the average ratio is roughly 48:52.[160] This means that the majority of a company's funds is supplied by financial institutions. Major lenders are often major shareholders in the large corporations that borrow from them, and naturally exert some influence on management.[161] However, the extent to which lenders can individually exert influence is limited by two factors. First, Japanese corporations generally spread their borrowings between several lenders which compete with one another. Second, the lending bank and the borrower often stand in an interdependent relationship because the company holds the bank's stock. Hence, a relationship of mutual trust is likely to exist between a target corporation and its major lenders. Were a shareholding bank to sell stock in response to a hostile tender offer or offer to buy, Japanese business circles would consider the act to be a shameful betrayal. It is no exaggeration to say that the future viability of the "sellout" bank would be endangered.[162]

4. *Reaction of Employees*. Labor unions in Japan are mainly organized along enterprise lines, rather than by industry or skill categories. Usually, individual enterprise unions are not strongly opposed to management. Unions prefer to maintain stable, long-term relationships with management and generally oppose anything that might alter the status quo. They tend to be highly suspicious of takeovers. The system of lifetime employment, although not as prevalent as is sometimes thought,[163] means that both management and labor are composed of persons who have been with the company for much of their working lives and are emotionally attached to it. Recently, an increasing number of companies have been taking advantage of this opportunity to keep stock in "friendly" hands by promoting employee shareholding programs; in quite a few companies, employee trusts rank among the five largest shareholders.[164] Thus, either because of union

159. Total liabilities ÷ shareholders' equity.

160. Bank of Japan, ed., KOKUSAI HIKAKU TŌKEI (Statistics for International Comparisons) 138 (1980). The figures are for 1978.

161. Banks are prohibited from holding more than 5% of any single domestic firm's stock; for insurance companies, the maximum permissible level is 10%. Antimonopoly Law, *supra* note 87, art. 11.

162. Not only the acquired company but also the members of its network would cease to patronize the bank.

163. *See* note 98, *supra*.

164. 78.1% of listed corporations had such programs in 1979, up 17.6% from 6 years before. TŌSHŌ YORAN (Tokyo Stock Exchange Survey) 55 (1981). Y.K.K. is a good example of a company that views employee shareholdings and non-listed status as a means to prevent outside control and takeovers. *See* MANAGING AND ORGANIZ-

pressure, stockholdings, or emotional identification, most employees can be expected to sympathize with management and resist takeover in any way they can. Even if the takeover is successful, if many of the workers quit the firm immediately, the effort will have been wasted.

At this point, it should be plain to the reader that one of the biggest problems in planning an acquisition is simply finding the shares to buy. On average, about 70% of a listed corporation's stock is held by groups who are likely to be "loyalists" to the firm; other companies (28.5%), lenders (38.8%), and employees (1.4%).[165]

B. Legal Aspects of Acquisitions

While keeping the Japanese system's inherent resistance to corporate acquisitions in mind, it is worthwhile to consider the various forms acquisitions can take and the pros and cons of each. The methods by which a foreign corporation may acquire an existing Japanese company are: (a) purchasing its assets, (b) subscribing to its newly-issued shares, (c) purchasing its outstanding shares, and (d) merging with it.

1. *Purchase of Assets*. An acquisition by purchase of assets is advantageous in that it can prevent the assumption of the target company's hidden liabilities. It also has some tax advantages, such as a step-up in basis and reclassification of depreciable lives for the assets.[166] However, the asset sales agreement must be approved by the shareholders of the target company,[167] and if some of them object, they can demand that the target company buy their shares at a fair price.[168] It may require substantial time and cost to negotiate the supplementary agreements which are necessary. These might include agreements for assignment of enterprise, re-employment of the work force, and management and technical assistance from outgoing executives. Still another problem is that the acquirer will have to secure governmental permits and licenses for operation of the new business; these cannot be "bought" from the target company.

ING MULTINATIONAL CORPORATIONS 436 (S. Davis ed., 1979). In quite a few listed companies, employee trusts rank among the five largest shareholders.

165. TŌSHŌ YŌRAN, *supra* note 164, at 53.

166. The tax disadvantages are that net-loss carryovers, reserves and allowances cannot be transferred. The same considerations apply to the other methods of acquisition that are discussed in the text, only in reverse.

167. COMMERCIAL CODE, arts. 245(1), 333. If the acquiring corporation is to purchase all the assets of the target, the agreement must be approved by the shareholders of both firms.

168. *Id.*, art. 245-2. However, they can make no such demand if at the same meeting the shareholders vote to liquidate the company.

2. *Subscription to Newly-Issued Shares*. Judged by Western criteria, many Japanese companies are not only undercapitalized but also undervalued on the stock market as well. This of course makes them attractive candidates for acquisition by stock purchases, as both control and assets are priced low. Stock acquisitions have the further advantage that there is no need to re-apply for business licenses or to re-register the assets of the firm.[169] However, the purchaser must beware of hidden liabilities.

Unless there are specific prohibitions or provisions for preemptive rights[170] in its articles of incorporation, the target corporation may issue any number of new shares to the acquiring firm so long as the issuing price is not "specially favorable".[171] If the price would be deemed to be "specially favorable", or if contrary provisions in the articles exist, the target's shareholders must approve the sale by a two-thirds vote.[172] Special price or not, there are limits to how many shares can be issued without diluting the stock to the detriment of all concerned. For this reason, it is suggested that this means of acquisition be used in tandem with a tender offer where a controlling interest is sought and the target is receptive.

3. *Purchase of Outstanding Shares (Tender Offer)*. A foreign company can purchase the outstanding shares of a target firm from its shareholders by placing a tender offer and making a "takeover bid". A tender offer is the most desirable method for purchasing outstanding shares because a bidder may condition the offer upon its drawing tenders in a number sufficient to give it a controlling interest. The number is stated in the offer itself; if the desired holding ratio is not attained, the bidder may revoke its offer.[173]

There are two major obstacles to a successful tender offer. First, if the target is an unlisted corporation, its articles may require board consent for all share transfers.[174] If such a provision is not already in the articles, the target's shareholders will probably not have time to react to the tender offer by inserting such a

169. Regarding tax consequences, *see* note 166 *supra* and accompanying text.

170. Preemptive rights are rare in Japan.

171. COMMERCIAL CODE, art. 280-2(1). Usually, any purchase price exceeding 85-90% of the market price of the shares is not considered to be "specially favorable". T. SUZUKI, SHINBAN KAISHAHŌ (Revised Corporations Law) 209 (1974). *See* 715 HANREI JIHŌ 100 (Tokyo High Court, Decision of July 27, 1973).

172. COMMERCIAL CODE, art. 280-2(2); art. 343.

173. *Shōken Torihikihō Shikōrei* (Securities Transactions Law Enforcement Order) art. 13(7) (Cabinet Order No. 321 of 1966).

174. Listed corporations are not allowed to have any restrictions on share transferability in their articles. Tokyo Stock Exchange, JŌJŌ SHINSA KIJUN (Listing Screening Standards) art. 4(9)(i).

provision.[175] Second, there simply may not be enough "floating shares" to make a tender offer worthwhile. Some listed companies have "floating shares" of around 10% of issued stock, with the rest of the shares safely in the hands of trustworthy affiliates banks, or other large investors who for various reasons will want to side with management. Article 210 of the Commercial Code (prohibition of treasury stock) would prevent the target company from buying up its own shares as a defensive measure, but nothing would stop these other major shareholders from announcing a rival tender offer. This would reduce even more the number of shares that a tender offer would raise, and it might result in further consolidating opposition to the bid.

Since the adoption of the tender offer rules in 1971, there have only been two successful tender offers in Japan. Both were "friendly" acquisitions, and neither was made in order to control management policy.[176] Regardless of how the FECL is implemented, capital structure and public opinion in Japan will probably outrule opportunities for hostile takeovers for some time to come.[177] However, where the target is open to the idea, there does seem to be room for creativity in combining a "friendly" tender offer with new share issues so as to achieve major shareholder status. Foreign firms should not assume that takeovers in Japan are impossible. Instead, they should seek to develop an intelligence-gathering network and strengthen their ties within Japanese business circles, in order to maximize potential opportunities.

4. *Mergers*. Under Japanese law, a foreign corporation cannot merge with a Japanese corporation.[178] Thus, a foreign company must first set up a Japanese subsidiary in order to effect a merger. The shareholders of both companies must approve the merger agreement by a two-thirds vote,[179] and dissenting shareholders may demand that the target company purchase their shares at fair market value.[180] Because of the low probability that two-thirds of the target's shareholders will agree to the merger,

175. The offeror must notify the target of the offer, but he can do this at any time before it takes effect. Securities Transactions Law, *supra* note 46, art. 27-3(1).

176. In one, Bendix Corporation raised its share in Jidōsha Kiki from 15.1% to 20% for tax reasons; in the other, Okinawa Electric Power acquired five power stations as part of a government-sponsored effort to rationalize power transmission in Okinawa. *See* Yaō, *Okinawa Denryoku no Kabushiki Kōkai Kaitsuke no Gaiyō* (Summary of Okinawa Electric's Stock Tender Offer) 724 SHŌJI HŌMU 168; Matsugawa, *T.O.B. Daiichigo Tanjō no Haikei to Igi* (The Meaning and the Background of the Birth of the First T.O.B.) 590 SHŌJI HŌMU 336.

177. Even if a bid succeeded, it might diminish "floating stock" enough that the target firm would be delisted, with considerable loss of prestige. *See* note 128 *supra*.

178. COMMERCIAL CODE, arts. 56, 57.

179. *Id.* arts. 343, 401.

180. *Id.* art. 408-3.

and because of the complicated procedures that are necessary, mergers and consolidations are not generally a feasible form of acquisition, especially where large targets are involved. Even if the target firm is small in size, there is nothing that a merger can do that cannot be done more easily by a purchase of assets or a stock acquisition.

V. TAX CONSEQUENCES

If the branch of a foreign company constitutes a "permanent establishment"[181] in Japan, the tax laws and treaties provide that it will be taxed on all its industrial or commercial profits from sources within Japan.[182] The 1981 amendments to the tax laws raised the standard tax rate for branches to 42% of taxable income.[183] For foreign corporations with paid-in capital of ¥100 million or less, this rate is reduced to 30% for the first ¥8 million of income.[184] No Japanese withholding tax is assessed upon remittances of profits from a branch office in Japan to its head office abroad, or upon payments by the head office of dividends which are based upon Japanese source income.

Japan applies an "arms-length" standard to tax issues involving transfer pricing.[185] Consequently, where a head office transfers goods that it or another of its branches manufactured outside of Japan to its branch within Japan, it is permitted to charge a "manufacturing profit margin" to the branch.[186] This means that the offshore manufacturing branch can charge the Japanese branch for costs of manufacture plus a reasonable profit on the sale, thereby increasing the amount of costs of goods sold that can be deducted from the Japanese branch's sales revenue. The same would be true (only in reverse) if the Japanese branch sold manufactured goods to the offshore branch. However, where an offshore branch transfers goods which it has purchased outside of Japan to the Japanese branch, it is not permitted to charge a

181. In most cases, the relevant tax treaty should be consulted to determine the parameters of "permanent establishment". Where no treaty applies, *see Hōjinzeihō* (Juridical Persons Tax Law) art. 138(1)(i) (Law No. 34 of 1965).

182. Japanese source income is income which is attributable to the permanent establishment. *Id.*, art. 14(1)(i). The definition of "attributable" is contained in article 138; it is deemed modified by relevant treaty provisions, if any. *Id.* art. 139. At ¥230 = $1, ¥100 million is about $435,000 and ¥8 million is about $35,000.

183. *Id.* art. 143(1). Previously, it stood at 40%.

184. *Id.* art. 143(2). At ¥230 = $1, ¥100 million is about $435,000 and ¥8 million is about $35,000.

185. Y. KOMATSU, GAIKOKU HŌJIN NO NŌZEIGIMU (Taxation of Foreign Corporations) 13.

186. *Hōjinzei Shikōrei* (Juridical Persons Tax Law Enforcement Order) art. 176(1) (Cabinet Order No. 97 of 1965).

"profit margin".[187] This result is obtained because, in this case only, the tax statutes ignore the arms-length rule and take the position that income cannot arise from a mere purchase.[188]

Subsidiaries and joint ventures (and of course acquired companies) are taxed on their worldwide income at the same corporate tax rates as are applied to other Japanese corporations. The rate schedules are "split-rate"; that is, the standard tax rate is reduced (a) for smaller companies and (b) whenever income is distributed currently as dividends.[189] For large companies, the rates are 42%[190] of taxable income if earnings are retained and 32%[191] if they are distributed currently as dividends. For companies with paid-in capital of ¥100 million or less, the rates (following the recent amendment) are 30% for the first ¥8 million of taxable income[192] if earnings are retained and 24%[193] if they are distributed currently as dividends. Income in excess of the ¥8 million figure is taxed at the upper-level rates of 42% and 32% respectively. It should be noted that a new joint venture or subsidiary cannot immediately take full advantage of the lower rates for distributed profits because the Commercial Code requires companies to set aside in an "earned surplus reserve" at least one-tenth of annual dividends paid until the reserve reaches one-quarter of paid-in capital.[194] After the reserve requirement has been met, companies are prohibited from issuing cash dividends that would impair the reserve.[195] Payment of cash and stock dividends will be subject to

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187. *Id.* The authors are indebted to Messrs. Gary Thomas and Jean-Francois Bretonniere for this information. *See* note 198 *supra*.

188. *Hōjinzei Shikōrei*, supra note 186, art. 176(1). The U.S.-Japan tax treaty takes the same position. Convention for the Avoidance of Double Taxation, March 8, 1971, U.S.-Japan, art. 8(4), 23 U.S.T., 7315 T.I.A.S.

189. The latter is intended to help eliminate "double taxation of dividends" and counteract the debt bias of Japanese corporations. The idea here is that if companies pay bigger dividends, stock investments will become more popular, thus reducing the cost of equity capital. Other tax provisions that help eliminate "double taxation" are the dividends-received deduction for individuals, the flat rate election for dividend income, and 100% exclusion of dividends received by a domestic company from another Japanese corporation. *Shotokuzeihō* (Income Tax Law) art. 8(2), (4) (Law No. 33 of 1965); Juridical Persons Tax Law, *supra* note 182, art. 23(1).

To prevent corporations from enjoying a windfall by virtue of the split-rate schedules, when the amount of dividends a corporation has received in dividends exceeds the amount it has paid out in dividends in the same tax year; one-quarter of the difference is taxed. *Sozei Tokubetsu Sochihō* (Tax Special Measures Law) art. 42(2) (Law No. 26 of 1957).

190. Juridical Persons Tax Law, *supra* note 182, art. 66(1).

191. Tax Special Measures Law *supra* note 189, art. 42. *See* note 184 for the equivalent amounts in U.S. dollars.

192. Juridical Persons Tax Law, *supra* note 182, art. 66(2).

193. Tax Special Measures Law, *supra* note 192, art. 42.

194. COMMERCIAL CODE, art. 288.

195. *Id.* art. 290.

a 20% Japanese withholding tax,[196] unless such rate is reduced or eliminated by provision of an applicable tax treaty.[197]

With respect to transfer pricing, because the "arms-length" standard is always applied to transfers between separate corporations, prices for transactions between a parent and its subsidiary or between different subsidiaries may include a "reasonable" profit element.[198]

In addition to corporate tax (juridical persons tax) imposed by the national government, there are also several taxes imposed by local governments on business organizations in Japan. These are the inhabitants tax (*jūminzei*) and the business activities tax (*jigyōzei*). The latter is deductible from income for purposes of computing the juridical persons tax.

When these levies are added to the corporate income tax, the overall tax burden for a typical venture capitalized at less than

196. Income Tax Law, *supra* note 189, art. 212(1).

197. The U.S.-Japan tax treaty reduced the withholding rate to 15% in general; this rate is reduced still further to 10% if the recipient of the dividends owns at least 10% of the voting stock of the paying corporation and no more than 25% of the payor's gross income consists of interest and dividends (not counting interest derived from normal moneylending activities and dividends and interest received from subsidiaries in which the payor owns at least a 50% interest). Convention for the Avoidance of Double Taxation, *supra* note 188, art. 12(2)(b).

198. With regard to this point, the authors are indebted to Messrs. Gary Thomas and Jean-Francois Bretonniere of the Tokyo Aoyama Law Office (affiliated with Baker & McKenzie), for their memo entitled *Basic Tax Considerations in Establishing a Subsidiary or a Branch in Japan of a French Company* (unpublished; on file with the UCLA PACIFIC BASIN LAW JOURNAL). Mr. Thomas is an expert in the area of Japanese tax law.

¥100 million would be calculated as shown in footnote 199.[199] As long as earnings are remitted currently, Japanese taxes can be minimized by conducting operations through a subsidiary. If the subsidiary does not distribute profits currently, the tax burden will be identical to the branch example until dividends are paid, when the withholding tax will increase the burden beyond that point. In most cases, the extra flexibility offered by a subsidiary or joint venture, together with the effect of the foreign tax credit in the parent firm's country, indicate that this form of organization is preferable to a branch.

199. Overall Tax Burden for Branches and Subsidiaries

	Branch	Subsidiary (profits distributed)	Subsidiary (profits retained)
1. Pre-tax net income (at ¥230=$1, = $130,435)	¥ 30,000,000	30,000,000	30,000,000
2. Less: business activities tax* (deductible for purposes of calculating (4) for the following year)			
-on first ¥3.5 million (6.6%)	231,000	231,000	231,000
-on next ¥3.5 million (9.9%)	346,500	346,500	346,500
-on remainder (13.2%)	3,036,000	3,036,000	3,036,000
	3,613,500	3,613,500	3,613.500
3. Taxable Income	26,386,500	26,386,500	26,386,500
4. Juridical persons tax			
-on first ¥8 million	2,400,0000	1,920,000	2,400,000
-on remainder	7,722,330	5,883,680	7,722,330
Total	10,122,330	7,803,680	10,122,330
5. Inhabitants tax (20.7% of (4))*	2,096,322	1,615,362	2,096,322
6. Total tax burden ((2) + (4) + 5))	15,832,152	13,032,542	15,832,152
-as a percent of pre-tax income	52.8%	43.4%	52.8%
7. Withholding tax on remitted earnings (U.S.-Japan treaty rate of 10%)		1,696,746	(in subsequent years)
		(6) + (7) = 49.1% of pre-tax income	(6) + (7) = 57.5% of pre-tax income

* *Chihōzeihō* (Local Tax Law) art. 72-22(1) (Law No. 226 of 1950). The rates shown are the maximum rates local governments are permitted to impose; actual rates may be a bit lower.

* *Id.*, art. 51(1), 314-5. Again, this is the maximum rate.

CONCLUSION

With the enactment of the FECL, the climate for direct investment in Japan may finally be improving. Examining the history of the Katakura lawsuit and subsequent developments, there is good reason to hope that the new law's ambiguities can be resolved in accordance with Japan's treaty commitments and the stated objectives of the FECL. For its part, the Japanese government's main task for the future will be to develop a consensus within its ranks for exercising the restraint which the FECL mandates. At the same time, foreign companies and their governments should strive to further research and understand the Japanese business environment so that they can work within it and not against it. If they take the "long view", intensify their intelligence-gathering efforts, and emphasize the development of a network of trade contacts, foreign corporations will be in a better position to seize the opportunities that exist for market entry and even corporate acquisitions. Both tasks will take time.