

Doing Business in Japan: Strategies and Practical Insights

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Japan accounts for almost 20 percent of the world computer market. For many years, the market grew significantly faster than that of the United States and the European Community, although the pace of growth has slowed considerably since 1991.

Overview of the Japanese Computer Market

Lag in ‘Downsizing’

Japan generally has lagged behind the United States and Europe in “downsizing” from mainframe and mid-range computers to personal computers (PCs) and workstations. For example, International Data Corporation (IDC), a market research firm and news-letter publisher, estimated in a report last year that personal computers constituted 37 percent of total 1991 hardware sales in Japan, compared with 53 percent in the U.S, and that mainframes accounted for 26 percent of hardware spending, compared with 18 percent in the United States. An IDC survey last year also indicated that Japanese users are moving much slower toward a client/server computing model: six percent of users are moving or have moved, compared with 22 percent in the United States. These differences, however, are narrowing.

Dominance of Proprietary Architectures

The Japanese market is more dominated by proprietary architectures, and is, therefore, more fragmented than the United States and Europe, with fewer *de facto* cross-vendor standards. This is especially so for PCs, where NEC controls approximately half the market and numerous other vendors share the other half. This pattern, however, also appears to be changing. With the promulgation of the DOS/V operating system (led initially by IBM), a group of United States and Japanese vendors are challenging NEC with a cross-vendor PC platform that meets the particular needs of Japanese language processing. Compaq and other U.S. vendors have been particularly aggressive in the PC market in the past year with pricing and advertising.

Reliance on Customized Software

Computer users in Japan historically have relied more on developing customized programs, rather than acquiring packaged software. This reflects, in part, the traditional reliance on larger, centralized systems and the fragmentation of the market; both factors have limited the development of a large target market for packaged software developers. For example, IDC last year estimated that Japan’s packaged software market was only 25 percent of that of the United States, while the market for customized services was almost the same as that of the United States. Input, another market research firm,

estimates that less than 20 percent of the software sold in Japan is packaged programs, compared with 60 percent in Europe and 75 percent in the U.S

This reliance on customized software is, however, also changing, with sales of packaged software expected to outpace other segments of the computer industry in the next few years. For example, IDC estimated in a report early last year that software revenue in Japan could total \$10 billion by 1995, representing 19 percent annual growth. Packaged software represents a particularly good opportunity for foreign companies, as evidenced by the recent success of companies such as Microsoft, Lotus and Oracle. In fact, the American Electronics Association estimated in October 1992 that 75 U.S. software companies have a presence in Japan, with 15 or so having established their operations in the previous year.

Strategies for Marketing in Japan

Distribution

Japan's distribution network for computer hardware and software, as with other products, is complex. The most difficult problem for foreign companies is often distributors' and retailers' loyalty to a single or limited number of vendors, making it difficult for the foreign companies to find outlets for their products. For example, a recent *Wall Street Journal* article on U.S. PC vendors' penetration of the Japanese market reported that, despite Compaq's aggressive in-roads in Japan, NEC still has 100 times as many dealers in Japan as Compaq. (Compaq sold 3,500 computers in Japan in the fourth quarter of 1992, compared with more than 200,000 for NEC, according to the article.) These loyalties are less entrenched for software, and have represented less of an obstacle for foreign software vendors entering the Japanese market.

Service and Support

As with other industries in Japan, users of computers require substantial after-sales service and support. Users tend to rely on their vendors for integrated turn-key help, and vendors that fail to meet this expectation may find their image in Japan tarnished. Vendors of hardware and software therefore need a substantial service and support capability and must demonstrate to their customers a commitment to the Japanese market. Japanese competitors will exploit any failure to provide such service and support.

Adaptation of Products

Products typically need to be adapted to the Japanese market in substantial ways. Computer hardware must be modified to support the particular requirements of the Japanese market, including the larger processing capability for Japanese-language processing. Software must be modified to support Japanese-language messages, help functions, commands and character input. Many software programs, such as those for accounting, word processing, computer-aided design and computer-integrated

manufacturing, also may require more fundamental changes because the underlying processes (accounting, character input, design and manufacturing) may be different in Japan. Other programs, including basic spreadsheet and database software for PCs, may be adapted without significant change in functionality and structure because the underlying functions do not differ significantly.

Structures for Market Entry

Among the most important issues for foreign companies entering the Japanese market are what form their entry should take, including (1) whether to “go it alone” or team up with a Japanese company to adapt, market, service, and support their products in Japan, (2) if the foreign company teams up with a Japanese partner, how the relationship should be structured, (3) to what extent the relationship with any such partner should be exclusive, (4) what kind of Japanese company represents the best potential partner, and (5) what role a physical presence in Japan plays.

Teaming Up or ‘Going It Alone’

Some U.S. companies have found success by establishing their own presence in Japan. The rewards of success in “going it alone” can be tremendous and, perhaps even more than in other countries, such rewards build on themselves. Indeed, an increasing number of foreign companies are trying this route. Among the more important factors for these companies are identifying, attracting, and retaining skilled and experienced technical, marketing, financial, and management personnel, typically one of the biggest obstacles to foreign companies in Japan. Other important factors are a strong reputation for quality, performance, and reliance that has spread to Japan, and a market niche not being served well by existing vendors.

Most U.S. companies, however, find it helpful to find a Japanese partner, at least in the early stages of market entry. Because of language difficulties, problems in understanding the particular needs of the market, difficulties in adapting products to meet the requirements of the market, obstacles to establishing a distribution network, and the cost of establishing a presence in Japan, many foreign companies find it difficult to “go it alone” entirely, especially at the beginning.

Form of Relationship

There are many ways for foreign and Japanese companies to structure their relationships. Three principal forms are (1) distributorships, (2) license arrangements, and (3) joint ventures. In practice, many relationships involve some combination of the three, especially with the recent emphasis on broad-based “strategic alliances” that combine elements of distribution, licensing and joint venture arrangements. In their simplest form, the three options are as follows:

Distributorships

Under a distributorship arrangement, the Japanese company markets and

distributes in Japan products that are developed and produced by the foreign company. For the foreign company that seeks to enter the market quickly, take advantage of an established distribution system, minimize investment, and generate additional revenue without a major commitment of management or other resources, this is often the most attractive structure. The disadvantages are, among other things, (1) generally smaller potential profit margins, (2) minimum of opportunities to generate goodwill and develop a corporate identity or brand name, and (3) minimum of direct feedback for adapting, improving, and enhancing products.

Distributorships are often attractive as a transitional form of market entry to Japan. Because in a distributorship arrangement the foreign company retains control over development and production, it develops knowledge about the market and, eventually, a greater ability to act on its own in Japan. This strategy, however, often requires that there be an understanding from the beginning of the relationship as to how long it will remain exclusive and how the parties will make the transition to a new structure.

License Arrangements

Often the least burdensome form of relationship to establish is a license arrangement, under which the Japanese company acquires rights to the foreign company's technology, including the right to develop, adapt, improve, enhance, produce, market, and distribute the foreign company's products. License arrangements have many of the same advantages and disadvantages as distributorships; indeed, such advantages and disadvantages often are even more pronounced with license arrangements. License arrangements can permit a foreign company to earn additional revenue without the investment of much, if any, management or financial resources but, because development and production are controlled by the Japanese company, there may be little, if any, continued exposure to and learning from the Japanese market.

Joint Ventures

A joint venture is potentially the most rewarding but often the most complex form of teaming up with a Japanese company. By finding the right Japanese partner and structuring the relationship advantageously, a foreign company can get the benefits of the knowledge, experience, goodwill and distribution network of a Japanese company and, at the same time, be in a position to develop goodwill and customer relations and learn first-hand about the requirements of the Japanese market.

Many foreign software vendors strongly prefer that their relationship with Japanese computer companies, especially hardware vendors, be nonexclusive.

Structuring and administering the joint venture, however, requires substantial management time and can be complex and fractious. Foreign companies that allow their Japanese partners to do everything often find that they get little more from the joint venture than they would from a distributorship or license arrangement. In addition, a joint venture typically requires that the foreign company contribute financial resources, although creative structures can be used to allow the foreign company to make part of its contribution through technology and to minimize the foreign company's out-of-

pocket financial costs.

Joint ventures are also a fragile form of market entry since, in the end, their success depends on a continued sharing of goals by the Japanese and foreign parties, whose interests may diverge over time as their own business strategies, product mixes, and relative dependence on each other evolve. The possibility (or even likelihood) of such evolution makes it critical that a joint venture be structured to account for change and to anticipate ways of ending the relationship amicably.

Exclusivity of Relationship

If foreign and Japanese companies establish a joint venture in Japan, they almost always agree that both parties will act exclusively through the joint venture for the development, production, and distribution of the products that are the subject of the joint venture. The joint venture need not, however, have exclusive rights to *all* of the foreign company's products and technology in Japan. Parties to distribution and license arrangements also face the issue of exclusivity.

Most potential Japanese partners, of course, want an exclusive relationship: if a Japanese company is making the commitment to adapt, market, service, and support a product in Japan, it typically wants to ensure that it does not have to share the benefits of success with other companies, especially its competitors. If, however, a foreign company is successful in its home market and has a product or technology that is especially in demand in Japan (as with many leading U.S. software companies), the foreign company may have the leverage to line up Japanese partners on a nonexclusive basis. This might mean that the Japanese company's rights are entirely nonexclusive. Alternatively, and more typically, this means something between complete exclusivity and complete nonexclusivity – for example, the Japanese partner obtains (1) exclusive rights to market and distribute a particular product, but not other products, (2) exclusive rights to market and distribute products of the foreign company on a particular platform or in a particular field, but not (at least on an exclusive basis) other platforms or fields, or (3) exclusive rights only for a specified (for example, one year) “head start” period.

Choosing a Partner

Choosing a Japanese partner requires a careful balancing of many factors, including the Japanese company's knowledge of and experience with the expected market for the foreign company's product, the scope and nature of the Japanese company's distribution network, its overall reputation, the contribution it can make to adapting the product to the requirements of the Japanese market, the extent of its commitment to and likely dependence on the foreign company's product, the likelihood that it could become a competitor or develop other loyalties, its size, its industrial group relationships (which can be a help in lining up some customers but foreclose opportunities with others) and the personal relationships with its management.

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Among the potential partners for most computer-related companies are:

Trading Companies

Large trading companies, or *sogo shosha*, have good generalized experience in and knowledge of Japan. They historically have had limited technical capability and computer market expertise, although in recent years they have increasingly developed such capability and expertise (often through specialized subsidiaries).

Computer Vendors

Computer vendors, of course, have technical capability and computer market expertise but may represent potential competitors. Many foreign software vendors strongly prefer that their relationship with Japanese computer companies, especially hardware vendors, be nonexclusive, since an exclusive tie-up with a single Japanese company limits the market for other platforms.

Traditional Manufacturers

Traditional manufacturers, such as steel, heavy machinery, and transportation equipment makers, have increasingly sought to team up with foreign hardware and software companies as part of their effort to diversify into advanced technologies. These companies often do not have the depth and breadth of computer industry expertise that computer vendors have, and they typically do not have the experience of the trading companies in bringing foreign products to Japan. Even so, they often offer good reputations, knowledge of the Japanese market in general, and reduced risk of direct competition. Indeed, many of these companies have a keen understanding of the market and the potential for the foreign company's products, often developed initially through systems integration work for their own manufacturing and distribution activities.

Presence in Japan

A physical presence in Japan, especially a wholly or majority-owned subsidiary, is often critical to the long-term success of a foreign company in the Japanese market. A physical presence is the best evidence of a foreign company's commitment to the Japanese market and to providing the service and support that Japanese customers value so highly. Indeed, for these reasons, Japanese companies that team up with foreign companies often encourage their foreign partners to establish a subsidiary in Japan.

Legal Protection for Computer Products

Forms of Protection

Japan has basically the same forms of legal protection as the United States for

computer software and hardware, including copyright, patent, and trade secret laws. There are, however, certain differences of which foreign companies should be aware, especially with respect to software.

Copyright

Computer software is protectable in Japan under copyright law, as in the United States. This was established by court decision in 1982 and was codified in 1985. Copyright protection does not extend to “programming languages,” “rules” (protocols), or “algorithms.” Because Japan is a member of the Berne Convention and the Universal Copyright Convention, copyrighted works originating in the United States and most European countries are also protected under Japanese law.

Formalities. There are no fixation or other formality requirements for copyright protection in Japan. Among other things, a copyright notice or registration is not required for protection or enforcement of a copyright interest. As in the United States, however, a copyright notice is a very common practice and is helpful for, among other reasons, preventing a defendant from seeking to mitigate damages by arguing that the infringement was innocent. In addition, copyright registration is available and offers evidentiary benefits as to certain facts included in the registration (for example, actual name of the author of an anonymous or pseudonymous work, first publication date of a work, and date of creation of a work) and priority in the event of conflicting assignments. Even so, as a practical matter, the benefits offered by registration have rarely, if ever, affected a legal proceeding.

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Ownership and Moral Rights. Unlike the United States, but similar to the continental countries of Europe, Japan accords an author moral rights such as (1) the right to decide whether or not to publish the work, (2) the right to decide whether or not to indicate his or her name as author of the work, and (3) the right to prohibit changes to or modifications of the work.

If a program is created by an employee at the employer’s instruction and within the scope of employment, the employer owns the copyright in the program, including any moral rights. Therefore, moral rights should not be a problem for works created by employees. This “work made for hire” doctrine, however, does not extend to works produced by independent contractors, and therefore companies using contractors to do programming (including localization, translation, and other adaptation) should address moral rights issues. Because assignments of moral rights are not enforceable, it is recommended that companies using contractors obtain the affirmative consent of those contractors to carry out the acts that might otherwise be circumscribed by moral rights, including rights to modify and develop derivatives of the contractors’ work and to distribute copies without identification of the contractors as authors.

Assignments. Copyright assignments are valid in Japan, as in the United States, and should be obtained from any person or entity that develops or contributes to the

development of a work outside the scope of an ordinary employer-employee relationship in which the “work made for hire” doctrine applies. Any copyright assignment should specifically include an assignment of the rights to prepare and control derivative works, since a general assignment of copyright does not include an assignment of such rights unless specifically indicated.

Patents

Protection. As in the United States, patent protection is available in Japan for any invention which meets three requirements: (1) industrial utility, (2) novelty, and (3) nonobviousness. The term “invention” is defined under Japanese patent law as “a highly advanced creation of a technical idea making use of a law of nature.” An invention is not novel if it is publicly known in Japan, publicly used in Japan, or disclosed in a printed publication in any country. An invention is obvious if it would be easy for a person with ordinary skill in the pertinent art to conceive of the invention.

A computer program is protectable if it can be characterized as a process which is an application of a law of nature, whether or not the process is incorporated in an apparatus or system. This principle is similar to that articulated in recent decisions of the U.S. Court of Appeals for the Federal Circuit.

Ownership. In the absence of an agreement to the contrary, individuals own their inventions even if the inventions are made or discovered within the scope of the employment relationship. Therefore, it is recommended that, as in the United States, companies require their employees to sign inventions assignment agreements. Such agreements are enforceable so long as the invention purported to be assigned falls within the scope of the employee’s employment duties. For example, such an agreement might not be effective to convey ownership of a patent on circuit design if the employee’s duties involve only sales and marketing. In the absence of an agreement, the employer acquires only a nonexclusive license under the patent, similar to “shop rights” in the United States.

Patent Process. In Japan, priority of patent applications is determined on the basis of first-to-file, as in most countries, rather than first-to-invent, as in the United States. Perhaps a more important difference of the patent system in Japan, also like that of most other countries, is that a patent application in Japan is automatically disclosed to the public 18 months after the application is filed. This “laying open” process permits competitors to know about patent applications “in the pipeline,” and therefore mitigates the kind of “submarine patent” problem often encountered in the United States (where patent applications are confidential until a patent issues). This process also permits competitors to design around a possibly forthcoming patent and to apply for closely related patents that may provide the competitors with leverage in the event of an infringement claim.

Patent applications in Japan are substantively examined by the Patent Office after a specific request for examination is made. If examination takes place, and the examiner considers the invention to be patentable, the Patent Office publishes the application for opposition by third parties. This “publication for opposition” process gives competitors

an opportunity to submit prior art and other bases for the invalidity of the applied-for patent.

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Once an application is published for opposition, the applicant acquires the same rights that a registered patent owner has, and the right to collect reasonable royalties then relates back to the initial “laying open” that occurred 18 months after filing. This process gives the applicant early protection during the application process. If the examiner receives no objection within three months after publication for opposition, or if the examiner rejects all oppositions filed, the Patent Office grants a patent to the applicant. If, as a result of the opposition, a patent is not granted, the applicant’s rights are void retroactively.

Post-Grant Proceedings. In part because competitors have the opportunity to challenge a patent during the application process, a patent, once granted and registered, has a stronger presumption of validity in Japan in comparison with the United States. Patents may be invalidated only by the Patent Office through invalidation proceedings or by the courts in appeals from such proceedings, not by the courts in connection with infringement actions. Therefore, in an infringement action, a court may not declare a patent invalid, nor can a declaratory judgment of invalidity be sought from the court. Nevertheless, invalidity arguments are commonly raised in infringement actions, since a court will stay the proceedings until the Patent Office completes invalidation proceedings if the defendant files for invalidation proceedings with the Patent Office and the court believes the patent is probably invalid. In addition, if the court determines that the claims as drafted were anticipated by prior art, it may interpret the scope of the claims to be limited to the working examples described in the patent specification. This remains a determination as to noninfringement, not a determination of invalidity, but involves the same prior art issues as an invalidity claim.

Trade Secrets

Trade secrets had been protected under tort and contract law before 1991, although injunctive relief against third parties was not available. In 1990, due in part to pressure in the GAIT TRIPs negotiations, Japan revised its Unfair Competition Prevention Act to include strong trade secret protection, and the revisions became effective in 1991.

The revisions were modeled on the Uniform Trade Secret Act of the United States, and accordingly the definition of trade secrets and the available remedies are very similar to those of the Uniform Act. Therefore, technical or business information is subject to trade secret protection if it is useful for business activities, is not publicly known, and is maintained as secret.

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The new trade secret law, however, has a major and disabling problem: Under current Japanese court procedures, there are no measures to protect the confidentiality of evidence submitted in a court action (as with the United States procedure for filing “under seal”). This is because the Japanese constitution requires that all arguments made and evidence presented in litigation be made public, and under current interpretation, trade secrets are not included in the limited constitutional exceptions to this requirement. Therefore, under current court procedures, a trade secret must, in effect, be disclosed if a misappropriation lawsuit is brought, and so enforcement of the trade secret will result in loss of confidentiality for the trade secret. It is recommended, therefore, that, where confidential information will be disclosed in Japan, foreign companies should do so pursuant to an agreement that any disputes will be submitted to and resolved in a U.S. court or in a binding confidential arbitration.

License and Distribution Agreements

Form and Style of Agreements

Computer products, including software programs, are distributed in a manner similar to that of the United States. That is, high-value programs are provided to end users pursuant to executed license agreements, and mass-market programs are distributed with a “shrink wrap” license.

Japanese companies often prefer agreements that are shorter and simpler than typical U.S.-style license or distribution agreements, but the larger and more internationally experienced companies are very familiar with U.S. practice and should not find U.S.-style documentation objectionable if the substantive terms and conditions are reasonable. Larger and more international Japanese companies are also very experienced with English-language documentation, and there is no need with such companies to prepare Japanese-language translations. On the other hand, with smaller and more domestically oriented Japanese companies, it may be useful for the foreign company to prepare a Japanese-language translation to assist the Japanese company to understand and comply with its obligations. If the foreign company is not used to Japanese-language documents and is uncomfortable with having contract terms set forth in Japanese, the parties can agree that the translation is provided solely for convenience and that only the English-language original is legally binding. Such provisions on the effect of a translation are believed to be enforceable in Japanese courts.

Warranties

Japan’s Civil Code provides for some warranties with respect to purchased goods, and these warranties likely will be applied by analogy to license arrangements. These warranties are, however, superseded by the Commercial Code for transactions between “merchants,” which include corporations. The Commercial Code provides that

in the case of a sale between merchants, the buyer shall, upon taking delivery of the subject matter, examine it without delay, and if he discovers any defects therein or any deficiency in quantity, he shall immediately dispatch notice thereof to the seller; otherwise he has no right to cancel the contract, to demand a reduction in the price, or to claim damages. The same apply where within six

(6) months the buyer discovers in the subject matter of the sale a defect that was not immediately discoverable.

Warranties provided by law may be disclaimed by parties to an agreement. Unlike the Uniform Commercial Code in the United States, Japanese law does not strictly restrict waivers or limitations of warranties or remedies, unless the liability results from an intentional or grossly negligent tort or contract breach.

Choice of Law

Under Japanese law, parties to an agreement may designate the law of any jurisdiction to govern the agreement, whether or not there are “minimum contacts” with the jurisdiction. Accordingly, the parties have freedom to select the law that will apply to the agreement.

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It is not unusual for the law of the foreign party’s home jurisdiction to govern an agreement with a Japanese company, although this is essentially a matter of negotiation. Where the foreign party establishes a subsidiary in Japan, and enters into agreements through its subsidiary, those agreements are between two Japanese companies. Even under these circumstances, the choice of foreign law to govern the agreement will generally be respected by Japanese courts. Many foreign companies agree, however, to have such agreements governed by Japanese law, in large part for marketing reasons.

Government Approvals

Japan has a variety of governmental requirements that apply to foreign companies doing business in Japan, depending on the form of entry and the nature of the technology introduced to the country. There are, however, two kinds of approvals that apply to all technology license agreements. Since almost all arrangements by foreign companies for the development, production, or distribution of computer hardware or software include a license component, these two kinds of approvals apply to almost all such arrangements.

Finance Ministry

Procedures

The Foreign Exchange and Foreign Trade Control Act requires that all kinds of agreements introducing technology into Japan be notified to the Ministry of Finance and to other related ministries, such as the Ministry of International Trade and Industry, for the purposes of currency control and business regulation. Except for technologies relating to national security, such as aircraft, weapons, explosives, nuclear energy, and aerospace development (Designated Technologies), prior notification is (as of January 1, 1992) no longer required, although the parties are still required to provide notice after

execution and effectiveness of an agreement. For the Designated Technologies, prior notification is required for agreements which include a cross-license or a parent-subsidiary license, or when the amount to be paid exceeds 100 million yen (about US\$850,000), and notification after the fact is sufficient for other agreements.

Where post-execution notice is permitted, it must be submitted to the Bank of Japan within 15 days after execution of the agreement. Any relevant ministry may order the parties to modify or terminate the agreement if the ministry determines that it violates national security, public order, public safety or national economic policy.

Effect

Administrative and even criminal sanctions may apply to the Japanese company for failure to file. As a practical matter, however, the more common problem with failure to file is that the Japanese company cannot remit any money under such an agreement without making the required filing because Japanese banks will not transfer funds in connection with such agreements unless a filing is identified.

Fair Trade Commission

Japan's Antimonopoly Act requires that certain international agreements be notified to the Fair Trade Commission (FTC) for the purpose of antitrust regulation. A new regulation effective as of March 30, 1992 reduced the scope of affected agreements and requires notification only after the fact regarding such agreements.

Agreements subject to the notification requirement include those (1) which constitute the exclusive license of a patent, know-how, or a program copyright, and (2) where the Japanese party has a market share of not less than 10 percent or is one of the top three companies in the relevant market, or where a condition setting the resale price is included. Notification must be submitted to the FTC within 30 days after execution of the agreement. The FTC may order any measures necessary to prevent performance of agreements it deems illegal.

As a practical matter, most agreements are submitted to the FTC in advance of execution to obtain informally the FTC's views on the agreements, including any potentially problematic provisions. The parties then typically agree to incorporate the changes suggested by the FTC. If the parties go through this process, and follow the FTC's recommendations, the FTC rarely, if ever, raises any further objections after the agreements are formally notified.