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Securities litigation picks up

Akihiro Hironaka and Jun Katsube of Nishimura & Asahi explain why listed companies are facing more lawsuits

The recent credit crisis has brought with it a surge of US-based securities litigation filings, stemming from the sub-prime loan debacle after 2007. The economic crisis continued to worsen, culminating in the bankruptcy of Lehman Brothers as well as the bail-outs of Merrill Lynch and AIG in 2008. NERA Economic Consulting reported that 130 federal securities class actions were filed in 2006, but this number jumped to 253 in 2008. What about the situation in Japan? It has been traditionally believed that Japanese society is litigation averse and is inclined to resolve problems through face-to-face out-of-court discussions. Until recently, this was true with regards to securities litigation as there had only been a small number of lawsuits concerning false statements in the disclosure documents of public corporations.

However, the situation has started to change. For example, on September 29 2008, 60 plaintiffs filed a securities litigation action against a major Japanese construction corporation with the Tokyo District Court, claiming damages of approximately ¥62 million (\$662,000). The number of plaintiffs and the claimed damages has gradually increased to 190 plaintiffs and approximately ¥190 million (\$2 million). In this case, the plaintiffs are alleging that the disclosure documents of the defendant contained false statements as to the amount of annual profit. Prior to the plaintiffs filing the lawsuits, the corporation voluntarily announced that it had amended the amount of annual profit of the past fiscal year on the grounds that it had readjusted the originally estimated costs for numerous domestic and foreign construction projects. Upon investigation by the Securities and Exchange Surveillance Commission of Japan (SESC), the Financial Services Agency of Japan (FSA) ordered the corporation to pay an administrative monetary penalty (*kachōkin*) of approximately ¥1.6 billion (\$17.1 million) for the incident.

The scale of the securities litigation in the example above is still far below that in the US. However, legislative efforts in 2004 have caused investors to consider such litigation as a more viable option than before, and such tendencies are continuing. Recent court decisions and changes in the social environment will further enhance these tendencies. The risks of securities litigation have been certainly rising, as corporations unexpectedly get into trouble in the Japanese securities market. The stakes of the litigation is expected to grow in terms of the scale of the lawsuits, as well as in terms of damage imposed upon corporate reputation. Japan is not a market that is free from costly and lengthy securities litigation for corporations who directly raise funds there.

Liabilities for false statements

The Financial Instruments and Exchange Act (the Act) of 2007, together with another relevant statute, sets out severe liabilities for false corporate statements in Japan. False statements in disclosure documents could lead to civil liabilities and administrative penalties for not only corporations, but also directors, auditors, certified public accountants, and auditing firms. In addition, in situations in which disclosure documents contain false statements, the corporation and the person who filed the documents could be liable for criminal penalties as well.

Different sets of provisions govern the civil liabilities for false statements in the offering disclosure documents and continuous disclosure documents. Offering disclosure documents are documents which corporations prepare and use for disclosure at the time of issuance or offering of securities, such as securities registration statements. Continuous disclosure documents are those which corporations prepare and use for disclosure after the issuance or offering of securities, such as annual securities reports, quarterly securities reports, semi-annual securities reports and extraordinary securities reports. Offering disclosure documents, such as securities registration statements, function as continuous disclosure documents while they are available for public inspection after the completion of issuance or offering of the securities. The provisions related to these matters are complex and it is impossible to explain all of them precisely here, but the following describes important features of the civil liabilities for false statements in the disclosure documents in Japan.

“Japan is not a market that is free from costly and lengthy securities litigation”

First, if offering disclosure documents contain false statements on material matters, the corporation which submitted such documents shall be held liable to compensate third parties who acquired securities through either a public offering or secondary distribution for damages. Such corporations shall assume civil liability for compensation even if they are not at fault. The amount of damages to be paid is the amount calculated by deducting the amount of the following items from the amount paid by the plaintiff to acquire the securities: (a) the market value of the securities at the time of the claim for damages; or (b) the disposal value of the securities, if the securities were disposed of before the time referred to in item (a). If the defendant proves that all or part of the plaintiff's damages were caused by any reason other than a decline in the value of the securities arising from the false statements in the offering disclosure documents, the defendant shall not be liable for that part of the damages. Thus, the burden of disproving causation and the amount of damages rests on the defendant.

Second, if continuous disclosure documents contain false statements on material matters, the corporation which submitted such documents shall be held liable to compensate third parties who acquired securities, during the period when the continuous disclosure documents were made available for public inspection, not through public offering or secondary distribution, for damages arising from the false statements up to the amount calculated according to the same formula as applied in the case of false statements in the offering disclosure documents explained above. Such corporations shall assume civil liability for compensation even if it is not at fault.

The provisions regarding civil liability for continuous disclosure documents were introduced in 2004. As explained above, issuers of securities may be liable for damages even if there is no fault on their part for the false statements in the continuous disclosure documents. The issuer's liability in this context is more severe in Japan than in the US, in that the US SEC Rule 10(b)-5 restricts the issuer's liability to cases where the defendants had *scienter*. The drafters of the Japanese Act considered that it would be necessary to provide stricter liability than in the US in order to fully protect investors' inter-

ests, as there is no class action or broad discovery system in Japan.

Further, the Japanese Act contains a provision which presumes the amount of the damages and causation. Under this provision, the amount of damages caused by the false statement in the continuous disclosure documents is presumed to be that calculated by deducting the average market value for one month after the day on which the existence of false statements was announced (Date of Announcement) from the average market value for one month prior to the Date of Announcement, for plaintiffs who acquired securities within one year prior to the Date of Announcement and continuously possessed them up to the Date of Announcement. If the defendant proves that all or part of the plaintiff's damages were caused for any reason other than a decline in the value of the securities arising from false statements in the continuous disclosure documents, the defendant shall not be liable for that part of the damages. Thus, the burden of disproving causation and the amount of damage rests on the defendant.

Finally, the drafters of the Act considered the difficulties for courts to determine the amount of damages in cases where the courts find that all or part of the plaintiffs' damages were caused by reasons other than a decline in the value of the securities arising from false statements in the continuous disclosure documents. The Act, therefore, provides that the court may determine a "reasonable" amount of damages, for which the defendant should not be liable, at its discretion, in cases where the nature of the damages makes it extremely difficult to determine its amount.

In 2005, an administrative monetary penalty was introduced as a sanction for false statements in disclosure documents. Under the administrative monetary penalty system, the SESC conducts an investigation. If it discovers a violation of certain provisions in the Act, the SESC then recommends that the FSA order payment of an administrative monetary penalty. Where the FSA has served a notice of a decision on the commencement of an administrative tribunal to the issuer of securities, and such corporation disputes the alleged false statements in the disclosure documents, an administrative tribunal is held before the FSA orders the corporation to pay the administrative

monetary penalty. The potential plaintiffs in a related civil damages lawsuit may then have access to the copies of the tribunal records. This has alleviated the difficulty in potential plaintiffs obtaining evidence, as the Japanese code of civil procedure does not provide a broad discovery mechanism as is available under the US legal system.

The Livedoor case study

The impact of the introductions of new provisions regarding the civil liability for false statements in the continuous disclosure documents was verified in the multiple and large scale lawsuits against Livedoor, at the time a rapidly growing operator of Japanese web portals. In one such lawsuit, thousands of individuals jointly filed a lawsuit against Livedoor. Five lawsuits were eventually filed by one of the plaintiff groups, and 3,320 individual investors and 25 corporations eventually became plaintiffs, claiming approximately ¥19.3 billion (\$ 206 million) in this one consolidated lawsuit. On May 21 2009, the Tokyo District Court ordered Livedoor and other defendants to pay compensation in the amount of approximately ¥7.7 billion (\$82.2 million).

The defendants in the case were Livedoor and its affiliate corporations, as well as Mr Takafumi Horie, the founder and then representative of Livedoor, and other executives of Livedoor or its affiliate corporations. These defendants were allegedly involved in illegally using means, such as spreading rumors, to cause price fluctuations in the corporation's share price, and for illegally submitting an annual securities report containing false statements on material matters, for the purpose of disguising the rapid growth of Livedoor. Prior to the filing of the civil litigation, Mr Horie and other executives were arrested in January 2006 on criminal charges regarding the incident, and the arrest of Mr Horie, who was a young, well-known entrepreneur, was a great shock to Japanese society. Therefore, his arrest led to a sharp decline in the share price of Livedoor and its affiliate corporations, as well as other corporations in securities markets in Japan.

In pursuing civil liabilities against Mr Horie and others for the incident, the plaintiffs alleged that the defendants' civil liabilities were clear because



About the author

Akihiro Hironaka has been a partner at Nishimura & Asahi (formerly Nishimura & Partners) since 2007. Nishimura & Asahi is a comprehensive law firm, and the largest law firm in Japan with 487 Japanese and foreign lawyers. Mr. Hironaka has focused his practice on complex and large scale litigation and arbitration, both international and domestic. His experience includes high-profile litigations involving alleged improper accounting practices, large-scale tax litigations, international construction disputes, cross-border product liability cases, and international arbitration. He has acted on behalf of well known clients in various countries and sectors, including banks and insurance companies. He has extensive legal experience, having worked as a judge in the Yokohama District Court (1998-2000), and also as a foreign attorney with the law firm of Arnold &

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Livedoor's continuous disclosure documents contained false statements, and the plaintiffs had to purchase Livedoor's shares at illegally inflated prices. This case presented important, but difficult legal issues regarding the application of the provisions explained above in securities litigation.

As explained above, the amount of damages arising from false statements is calculated based on the average market value before and after the Date of Announcement, and therefore, the interpretation of Date of Announcement is of critical importance. Livedoor did not voluntarily announce that its continuous disclosure documents had contained false statements before the arrest of Mr Horie. Rather, media coverage over the criminal investigation of Livedoor triggered the substantial drop in the market share price. If the Date of Announcement is interpreted to be the day after such media coverage, the damages calculated would be significantly lower, because Livedoor's market share price had become very low on the Date of Announcement under such interpretation. The Tokyo District Court, under an aggressive interpretation in favour of the plaintiffs, found the Date of Announcement to be the day on which the prosecutor in charge of the investigation announced, through media coverage, material facts regarding the false statements in the continuous disclosure documents, and awarded a substantial amount of damages to the plaintiffs.

The Tokyo District Court found that the amount of damages which the plaintiffs suffered was ¥585 (\$6.2) per share. However, the court determined, at its discretion, that only 34.2% of such damages, which was ¥200 (\$2.1) per share, should be awarded to the plaintiffs because the remainder of the damages were caused by reasons other than a decline in the value of the securities arising from false statements, such as the commencement of the criminal investigation against Livedoor, the arrest of Mr Horie, and the increased possibilities of delisting from the Tokyo Stock Exchange. Because the Act gives courts broad discretion regarding the value of damages, the amount by which damages are reduced may vary depending on judges. In another lawsuit against Livedoor filed by Nippon Life Insurance, the Tokyo District Court found that the amount of the plaintiffs' damages arising from the misdeeds of Mr Horie and others was

¥585 (\$6.2) per share, the same as above, but the court determined that 70% of such damages should be awarded to the plaintiffs at its discretion.

There are different views with regards to the interpretation of "damages arising from the false statements," and such differences may be one of the reasons that different judges on the Livedoor cases reached different conclusions. One view is that the amount of damages is the difference between the actual purchase price paid by the investor and the hypothetical market share price assuming that no false statement existed in the disclosure documents. Another view is that damages should be the amount of the drop in the market share price triggered by false statements in the disclosure documents. There is yet another view that, the actual purchase price paid by the investor itself is the amount of the said damages, because the investor would not have bought the shares had such false statements not existed.

The Tokyo District Court judgement explained above, which awarded only ¥200 (\$2.1) per share to the plaintiffs, appears to take the first view, and decided that the amount of the drop in the share price caused by events such as commencement of the criminal investigation against Livedoor, the arrest of Mr Horie, and the increased possibilities of delisting from the Tokyo Stock Exchange should not be included in the damages to be awarded to the plaintiffs.

However, this is a matter of judges' discretion given by the Act, and therefore judges who take the same view with regards to the interpretation of the damages may reach substantially different conclusions.

Securities litigation in the future

It is no longer rare in Japan for a large number of investors to file a lawsuit, claiming a large amount of damages in total against corporations that have made allegedly false statements in disclosure documents, intentionally or unintentionally. Even without a class action system, some attorneys have become used to organising enormous numbers of potential plaintiffs and filing consolidated large-scale lawsuits against corporations, with the assistance of communication tools such as the internet once such fraudulent disclosure incidents have become public via media coverage.

Additionally, the recent rapid increase in the number of lawyers in Japan will have significant effects on the number of securities lawsuits in future. Over the past 10 years, the number of Japanese lawyers has rapidly increased from approximately 17,100 in 2000 to 28,800 in 2010, under the auspices of the government's policy determined in 2001. The government originally anticipated that the increased number of lawyers would create fair competition among Japanese lawyers which will contribute to easier access to legal services for Japanese nationals. However, many have argued that the rapid growth in the number of Japanese lawyers has created excessive competition, especially among smaller law firms. This excessive competition, if continued, may generate a larger number of US style litigations than before.

It is expected that securities litigation will steadily increase in the future, and that the risks of securities litigation will be higher. Corporations in Japan are no longer safe from the threat of large-scale litigation if they are unexpectedly caught by problems in disclosure. In addition, new accounting standards are being introduced in Japan, and auditing methods are becoming more rigorous. Disclosure of quarterly securities reports have already been made mandatory. Some commentators even advocate the introduction of a class action system to fully protect investors' interests from illegal attempts to prepare disclosure documents containing false statements to disguise corporations' financial status. Surprisingly, the Japan Federation of Bar Associations is even discussing the introduction of depositions in Japan, modelled on the US legal system, and such an evidence collection device, if introduced, would increase the risk of litigation in Japan.

The magnitude of litigation results, as well as the high costs of pursuing such large scale litigation, may have a significant impact on the performance of investments in Japanese corporations. Further, the damages paid to the plaintiffs in securities litigation will be paid out of the assets of the corporations shared by the remainder of the shareholders. Therefore, the trends in securities litigation in Japan will continue to be important for not only Japanese corporations, but also foreign investors which control such Japanese corporations.



About the author

Jun Katsube is an associate at Nishimura & Asahi and graduated with an LLB from Hitotsubashi University in 2004. Mr. Katsube has worked on complex litigation cases concerning corporate control conflicts, breaches of representations in M&A transactions and cross-border disputes. He is working for a notable Japanese company on a large-scale securities litigation suit, which will be a bellwether case for important legal issues regarding securities litigation in Japan. He also works on corporate mergers and acquisitions, compliance, and other general corporate legal issues. He is admitted to practice law in Japan.

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