



LEGAL DEVELOPMENTS FOR DIRECTORS AND OFFICERS IN JAPAN

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Until quite recently, lawsuits against directors of a Japanese company were rare. Whether due to the current global financial crisis, a change in corporate governance standards arising from new Japanese corporate laws and stock exchange regulations, and/or a rise in shareholder activism in general, director lawsuits in Japan are rising and show few signs of abating (but are still relatively low in comparison to the United States). For example, the Japanese Supreme Court has recently supported various lower court decisions ordering company directors to pay significant damages for failing to comply with their corporate responsibilities. In *Janome Sewing Machine Co., Ltd.* (Supreme Court decision of October 2, 2008), five ex-directors were ordered to pay JPY58.3bn in damages to the company, arising from the directors yielding to extortion demands from an organised crime operative. In *Duskin Co., Ltd.* (Supreme Court decision of February 12, 2008), two former directors were ordered to pay JPY5.3bn for failing to disclose past sales of food contaminated with unlawful chemicals that were later discovered in an official inspection. In *Hokkaido Takushoku Bank* (Supreme Court decision of January 28, 2008), 14 ex-directors were ordered to pay JPY10.1bn due to their negligence in connection with various loans that had become uncollectable.

Given this clear change in the trend of lower court precedents endorsed by the Japanese Supreme Court, it is important that directors and executive officers of Japanese companies, as well as other relevant parties such as shareholders, have a precise understanding of the position and responsibilities of directors and executive officers under Japan's corporate statute – the Companies Act of Japan (*kaisha-ho*, Law No. 86 of 2005) (Companies Act).

Who can be held liable for corporate misconduct?

Who can be held responsible for corporate malfeasance depends on the corporate form selected. The joint stock company (*kabushiki kaisha*) is the most common organisational form used in Japan, and all references in this chapter to a 'company' mean a joint stock company. A company's directors (*torishimari-yaku*), executive officers (*shikko-yaku*) and statutory auditors (*kansa-yaku*) are normally the primary focus when claims are made against a company. A company will have executive officers if it adopts a corporate governance structure of a board of directors with committees (as discussed below). Statutory auditors are separate from management and play a unique corporate governance role in Japan in comparison to other jurisdictions by being tasked with monitoring the directors' adherence to corporate governance and reviewing the company's financial statements. The duties and liabilities of statutory auditors themselves are very different from those of directors and executive officers, a discussion of which is beyond the scope of this article. Instead, this chapter focuses on the duties and liabilities of directors and executive officers of a Japanese company (collectively, 'company representatives'), and the liability insurance available for such persons.

A company organised in Japan can have a board of directors with or without committees. For a company without committees (which is the most common corporate governance structure in Japan), directors are appointed to make decisions as a board on corporate affairs, the board selects one or more directors to serve as the representative directors who are responsible for executing the business of the company, and statutory auditors play the role described above. For a company with committees, directors are appointed to make decisions on high-level corporate affairs since the board cannot directly execute the business affairs of the company. Instead, the board appoints executive officers (who may also serve as directors) to execute the business of the company, some of whom have the power to bind the company in a manner similar to representative directors (such executive officers are often referred to as representative executive officers).

Principal duties of company representatives under Japanese corporate law

The relationship between a company and its company representatives is governed in Japan by the principles of agency. As an agent for the company, a company representative has an obligation to conduct the affairs of the company with the care of a 'good manager' (the duty of care). More specifically, company representatives are obligated to perform their duties faithfully on behalf of the company (the duty of loyalty). The Japanese Supreme Court has indicated that a company representative's duty of loyalty complements a company representative's duty of care and has deemed both duties to be part of a company representative's fiduciary duty.

Japanese courts have developed the duty of care by requiring company representatives to comply with the following obligations:

Duty of compliance with law and the Articles of Incorporation

A company representative has an obligation to comply with applicable law and the articles of incorporation of the company. Since compliance with the company representative's fiduciary duty is required under the Companies Act, any breach of the company representative's fiduciary duty constitutes a breach of Japanese law. However, a breach of law extends far beyond a breach of fiduciary obligations, encompassing any violation of any law related to the company, including, without limitation, public order. While a company representative does not need to have a thorough knowledge of all laws applicable to his company, with the assistance of the company's business units and legal department he should understand the regulated activities and an outline of the main laws applicable to the company's corporate activities, including sanctions and damages that may be imposed in the case of a violation.

Duty of reasonable management

Recently, lower courts in Japan have applied towards company representatives a Japanese version of Delaware's 'business judgment rule,' in which a court limits its inquiry to whether or not the board exercised reasonable business judgment in light of the circumstances at the time of the relevant decision. While the Supreme Court of Japan has not rendered a decision on this matter that would serve as a conclusive precedent regarding the force and effect of the business judgment rule, many Japanese courts

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hearing shareholder derivative lawsuits generally apply the business judgment rule. The rule essentially holds that, so long as a company representative shows (i) that there were no negligent errors in the finding of the material facts relevant to the decision making, and (ii) there was no material unreasonableness in the contents and the process of the business decision according to the standard of ordinary management, the company representative should not be held liable for damages resulting from such a decision. However, Japanese courts are unlikely to follow the business judgment rule in cases that involve a conflict between the interests of the company and the interests of the company representative(s) and cases where violations of laws are in question.

Duty to monitor

The Companies Act requires that the directors of a Japanese company oversee the activities of the other directors, and, for companies that have adopted a board of directors with a committees corporate governance scheme, directors also have a duty to monitor the activities of the executive officers. The duty to monitor was powerfully highlighted on 20 September 2000 when the Osaka District Court awarded US\$775m against some of the defendant directors of Daiwa Bank due in part to their breach of their duty to monitor. In this decision, which involved the fallout from the scandal and cover-up at Daiwa Bank in 1995 in relation to trading losses incurred at its New York branch, the court indicated that representative directors and certain managing directors are subject to the obligation to establish internal control systems and that other directors have the obligation to monitor the obligations of such representative directors and certain managing directors. In the case of large companies, the court conceded that it is practically difficult for all directors to monitor the day-to-day operations of other directors and stated that directors who have reasonably relied upon the sound management of other directors would not be liable for any damage incurred as a result of any breach of such other directors' obligations, thereby limiting the liability of directors of large companies. Instead, the Companies Act stipulates the duty of the directors of a large company to establish and maintain an internal control system and other systems necessary to assure the appropriate operation of the company.

Liabilities of company representatives due to breach of their duties

Article 423 of the Companies Act states that a company representative is only liable when he is negligent in performing his duties ('the General Liability Provisions'), except in the following three instances where strict liability applies (ie, there are no defences that a company representative can raise, such as having met his duty of care):

- (1) for directors, the actual value of an asset contributed to the company in exchange for shares to be issued at the time of incorporation is much less than the minimum value of the shares stated in the company's articles of incorporation when the incorporator solicited subscribers for the shares issued on the incorporation
- (2) a company representative engages in a transaction that is in contravention of Japan's conflict of interest provisions; and
- (3) a company representative offers a pecuniary benefit to a shareholder in exchange for the shareholder voting.

If any of the actions are taken pursuant to a resolution adopted by the board of directors, then the directors who assented to such resolution are also presumed to have performed such act. Directors who participated in the board resolution are presumed to have assented to such resolution unless they specifically expressed their dissent in the board minutes.

Company representatives owe duties to the company. Accordingly, it is the prerogative of the company (acting through its statutory auditors or its audit committee) to sue company representatives for any breaches of their duties. However, a company representative breach of duty claim can form the basis of a shareholder derivative action. In addition, if a company representative performs an act in violation of law or the company's articles of incorporation and such action can cause irreparable damage to the company, then a shareholder may bring an action for injunctive relief on behalf of the company. A shareholder derivative lawsuit may be initiated against a public company only by a shareholder who has held shares continuously for at least six months.

Company representative malfeasance may also give rise to claims by third parties. Pursuant to Article 429 of the Companies Act, company representatives are liable to third parties for acts that exhibit 'wrongful intent or gross negligence' in the performance of their duties. This is a special statutory liability provision intended to protect third parties engaging in transactions with a Japanese company. Among other things, if a company representative provides false information in any of the following activities, he is liable to compensate any third party for damages incurred as a result of such activities, unless he successfully proves he did not act negligently (a shift in the burden of proof to the company representative):

- Giving false notice about any material information that needs to be notified when making an offering of shares, stock options, corporate bonds or bonds with stock options, or making false statements in explanatory documents that are used for such offering.
- Making false statements regarding any material information in a financial statement, a business report or supplementary schedules attached to any of these, or an extraordinary financial statement.
- Making a false registration or giving a false public announcement.

In addition to civil liability, a company representative can be held criminally responsible. For example, a company representative who violates certain obligations under Japan's Financial Instruments and Exchange Act or certain Japanese health and safety, environmental and anti-trust laws can be held criminally liable. However, in Japan a company representative generally cannot be held criminally responsible for the criminal acts of the company.

Methods to limit company representative liability

The civil liability of a company representative can be limited in the following ways:

Statutory cap (for a breach of a General Liability Provision only)

If a company representative acted without gross negligence or wilful misconduct, then the maximum amount of his liability to the company arising from the breach of a General Liability Provision can be fixed subject to certain strict approval procedures. Depending on the status of the company representative at the time of the cause of liability, the Companies Act has specific monetary caps on liability based on a multiple of the company representative's 'total annual remuneration' (which is the sum of the company representative's (i) highest annual base salary, (ii) highest annual bonus, and (iii) the equivalent of one year's retirement allowance):

- **Representative director and representative executive officer** (which means a company representative who is responsible for executing the company's business and has binding, signing authority): the sum of six times total annual remuneration, plus the value of stock option benefits.
- **Outside director** (which means a director who does not manage and has never managed the corporate affairs of the company or any of its subsidiaries as a director, executive officer, manager, or other employee and who is not currently an employee of the company or any of its subsidiaries): the sum of two times total annual remuneration, plus the value of stock option benefits.
- **Ordinary director and executive officer** (a company representative who is not a representative director, representative executive officer or an outside director): the sum of four times total annual remuneration, plus the value of stock option benefits.

To effect a statutory cap on liability, either (1) all the statutory auditors or the members of the company's audit committee agree to propose the liability limitation to the shareholders and two-thirds or more of the company's shareholders approve the liability limitation, or (2) all the statutory auditors or the members of the company's audit committee agree to propose the liability limitation to the board, and the company's board of directors must approve the cap (so long as the company's articles of incorporation permit the directors to approve this type of arrangement), unless shareholders holding 3% or more of the total voting power of the company object to the board's approval.

As a result of the foregoing approval sequence, it is important to note that the statutory cap can be perfected only after the director has committed the misconduct. Therefore, a director cannot assume upfront that his conduct always will benefit from the statutory cap and will be exposed to the risk of its ultimate unavailability.

Liability limitation agreement (for a breach of a General Liability Provision only)

An outside director (only) is permitted to execute an agreement with the company limiting his liabilities to the company arising from the breach of a General Liability Provision, if such director has performed his duties without gross negligence or wilful misconduct. Pursuant to such an agreement, the potential liabilities of an outside director may be contractually limited to the amount specified in the articles of incorporation or an amount equal to the statutory cap for an outside director (as discussed above), whichever is higher. This type of agreement is permissible only when the company is authorised to enter into such agreements by its articles of incorporation. Furthermore, the material provisions of the liability limitation agreement and the remuneration of the outside directors should be disclosed to the shareholders in the company's annual business report.

A liability limitation agreement can be more favourable in comparison to the statutory cap because no shareholder approval is required to enter into the agreement and the arrangement is typically executed in connection with the appointment of the outside director; therefore, the liability cap is effective before the misconduct has been committed (which provides the outside director with upfront comfort concerning liability limitation).

Unanimous approval

A company representative can be exempted from liability with the unanimous consent of all shareholders. For a company with many shareholders, attaining unanimity could be difficult.

Insurance

As discussed in greater detail below, D&O insurance in Japan generally covers damages and defence costs payable in relation to claims by shareholders or third parties against company representatives for the economic damage incurred by them due to their negligent mismanagement. In our experience, D&O insurance generally is not available if the company representative acted with gross negligence or the subject transaction represented a conflict of interest.

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The D&O insurance market in Japan

In Japan, it is common for companies to purchase D&O insurance. Many non-life insurance companies offer D&O insurance products and most public companies purchase D&O insurance for their company representatives. There is no standard D&O policy form, and insurance companies in Japan use policy forms that differ from one another, but Japanese D&O insurance policies share a number of common features that are discussed below.

Insured

Japanese law permits D&O insurance to cover a company's directors, statutory auditors, executive officers and senior operating officers (*shikko-yakuin*). The company may also include the directors, statutory auditors, executive officers and senior operating officers of its subsidiaries as an insured.

Coverage

D&O insurance in Japan is typically underwritten on a claims-made basis, not an occurrence basis. When a policy is written on a claims-made basis, the insured will be covered pursuant to the terms of the policy in effect at the time the claim is made so long as the act giving rise to the claim did not occur prior to the starting date of the initial policy period (whereas under an occurrence-based policy, even though the policy may have expired, a claim still can be made provided the policy was in force at the time that the incident occurred). A claims-made basis policy can be advantageous because every time the company increases the limits of its policy, the insured will be covered for the higher limits during the policy period (which makes it easier to keep pace with inflation and rising damage awards).

D&O insurance in Japan normally covers the damages and the defence costs arising from lawsuits, arbitration, mediation, settlement and other proceedings. The D&O insurance policy will stipulate an aggregate limit amount that the insurance company will pay during the policy period. However, in Japan most insurance companies will not pay all of the damages – the insured will need to pay a deductible amount before the insurance company's payment obligation is applicable. In addition, a common feature in Japanese D&O insurance policies is for the policy to cover only a certain percentage (eg, 95%) of the damages and defence costs in order to create an incentive for the insured to reduce the damages. Advance payment for defence costs is permissible under many D&O insurance policies in Japan provided that if it is determined that the D&O insurance does not cover the concerned claim the insured must return the advanced defence costs.

Exclusions

In general, Japanese D&O insurance policies do not cover damages arising from:

- Conflict of interest transactions or illegal acts, such as bribery, insider trading, committing a criminal act etc
- Derivative lawsuits, as it would appear improper for the company to fund premium payments under such circumstances. However, as discussed below, such damages can be covered by an endorsement paid by the insured.
- Violations of the US Employee Retirement Income Security Act, the US Racketeer Influenced and Corrupt Organization Act, or the insider trading regulations under the US Securities Exchange Act of 1934. This exemption applies to Japanese companies that have subsidiaries and/or branches operating in the United States. Many of the foregoing violations are exempted under standard US underwritten D&O insurance policies, and so Japanese insurance companies have followed suit and may expand the specific exemptions in the future in line with US D&O insurance practices.
- Other exclusions include (i) acts that occurred prior to the starting date of the first policy period, (ii) extraordinary risks such as environmental pollution and asbestos, and (iii) claims made by other insureds, a parent company, subsidiaries or major shareholders (in order to avoid potential collusion or an internal battle relating to a change of control situation).

Premiums

Premiums for a D&O policy are determined by the insurance company. There are no specific Japanese laws or regulations that set a floor or ceiling on the premium amount that an insurance company may charge in Japan, so prices are typically determined by market forces and other factors selected by the insurer (eg, the industry in which the policyholder operates, financial condition of the policyholder, claim history, etc). In addition, most D&O insurance policies in Japan require the insured to pay, via an endorsement clause, approximately 10% of the premium amount as consideration for coverage against the risk of loss associated with derivative lawsuits (without the possibility for reimbursement by the company).

Endorsement

In order to cover certain excluded risks and costs, an endorsement clause can be acquired. The most common endorsement clauses available in Japan include: (i) an endorsement to cover damages due to a derivative lawsuit (as discussed above), (ii) an endorsement to cover acts that occurred prior to the starting date of the current D&O policy period (typically requested when the company changes D&O insurance providers), and (iii) an endorsement to cover defence costs when a company intervenes in derivative suits to support an insured. ■