The Corporate Counselor

- Insights into Japanese Corporate Law -

August 2022/No. 34

DUTIES AND LIABILITIES OF DIRECTORS IN JAPAN

On July 13, 2022, the Tokyo District Court ordered four former executive directors of Tokyo Electric Power Company ("TEPCO") to pay JPY 13.32 trillion (USD 97 billion) to the company for damages caused by the accident at the Fukushima No. 1 nuclear power plant following the March 11, 2011 earthquake and tsunami that led to three reactor meltdowns. The amount is believed to be the largest damage award ever issued in a derivative lawsuit in Japan. Lawsuits against directors of Japanese companies are not as frequent as in other jurisdictions (namely, the United States) for various reasons, such as the fact that Japanese civil procedure does not permit class action lawsuits in most instances. However, damage awards are reaching atmospheric heights and claims against directors are increasing in frequency in Japan, due in part, to a rise in shareholder activism. While board representation can offer many benefits to an investor in a Japanese company (*e.g.*, influence upon decision making and access to confidential information), it is important for directors of Japanese companies (as well as shareholders with director nomination rights) to have a clear understanding of their responsibilities and potential personal liabilities under Japanese corporate law so they can perform an accurate cost-benefit analysis concerning board membership.

This edition of the *Corporate Counselor* aims to provide an overview of the risks associated with serving as a director of a Japanese company and how to mitigate potential civil liability by explaining: (i) who can be held liable for corporate misconduct in Japan, (ii) the principal fiduciary duties of directors under Japanese corporate law, (iii) the potential liabilities to which a director can be exposed, and (iv) the common methods to reduce the personal liability of a director.

Who Can be Held Liable for Corporate Misconduct?

The legal form of an entity impacts who within it can be held responsible for corporate malfeasance. The joint stock company (*kabushiki kaisha*) is the most common organizational form used in Japan and the only practical form for a public company, and all references in this newsletter to a "company" mean a joint stock company. A company's directors (*torishimari-yaku*), executive officers (*shikko-yaku*) and company auditors (*kansa-yaku*) are normally the primary focus when claims are made against a company. A company will have executive officers only if it adopts a corporate governance structure of a board of directors with three committees (namely, a nominating committee, audit committee and a compensation committee). Most privately owned companies in Japan do not have committees. Company auditors in Japan are separate from management and play a unique corporate governance role in comparison to other jurisdictions by being tasked with the responsibility to monitor the directors' and executive officers' adherence to corporate governance requirements and to review the company's financial statements. The duties and liabilities of company auditors themselves are very different from those of directors and executive officers, a discussion of which is beyond the scope of this newsletter. Accordingly, this newsletter focuses on the duties and liabilities of representative, executive and non-executive directors of a Japanese company (each of which are referred to as a "director," unless otherwise noted) and executive officers.

Fiduciary Duties of Directors under Japanese Corporate Law

The relationship between a company and its directors is governed in Japan by the principle of agency. As an agent for the company, a director has a fiduciary obligation to conduct the affairs of the company with the "duty of care of a prudent manager." Given the broad reach of this duty on its face, the Companies Act of Japan (*kaisha-ho*, Law No. 86 of 2005) (the "Companies Act") and Japanese court precedents have amplified and buttressed the concept of the duty of care of a prudent manager by requiring directors to also comply with the following duties:

Duty of loyalty. Directors have an obligation to perform their duties faithfully to the company, which includes a requirement to (i) keep the company's material information confidential, and (ii) abstain from engaging in activities that compete with the company or that conflict with the interests of the company (unless

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the board of directors provides its prior approval upon disclosure of all the material facts). A conflicted transaction that does not receive prior board approval will be void between the company and the director. There also is a possible breach of the duty of loyalty if a director personally takes advantage of a potential business opportunity that is initially presented to the company.

Duty of compliance with law, shareholder resolutions and the Articles of Incorporation. A director has an obligation to comply with applicable law, shareholder resolutions and the Articles of Incorporation of the company. Since compliance with a director's duty of care of a prudent manager is required under the Companies Act, any breach thereof by a director constitutes a breach of Japanese law. However, a breach of law extends far beyond a breach of a director's duty of care of a prudent manager, and encompasses a violation of any law related to the company. For example (i) in 2009, the directors of Livedoor were held liable for false statements appearing in the company's annual securities report and were ordered to pay individual investors compensation for damages amounting to approximately JPY 7.7 billion (USD 57 million), which was eventually reduced to JPY 227 million (USD 1.7 million) in connection with settlement negotiations, and (ii) in 2019, three ex-directors of Olympus Corporation were ordered by the Tokyo High Court to pay JPY 59.4 billion (USD 440 million) to the company in relation to damages arising from accounting irregularities.

While a director does not need to have a thorough knowledge of all laws applicable to the company, with the assistance of the company's business units and legal department, a director 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 to monitor. A director has an obligation to oversee the activities of the other directors and employees and, for companies that have adopted a board of directors with a three committees corporate governance scheme, directors also have a duty to monitor the activities of the company's executive officers. If a director knowingly or negligently overlooks the misconduct of another director, executive officer or an employee and the company suffers damages arising from such misconduct, then the director(s) who overlooked such misconduct may be liable for the damages suffered by the company (in addition to the person who committed the misconduct). Furthermore, the board of directors of a "large corporation" (a company with capital of JPY 500 million or more or with total debts of JPY 20 billion or more based on its most recent financial statements) must adopt a policy for the establishment or confirmation of internal control systems.

The duty to monitor was powerfully highlighted on September 20, 2000, when the Osaka District Court ordered current and former Daiwa Bank directors to pay to the bank USD 775 million in damages due to a breach of their duty to monitor. In this landmark decision, which involved fallout from the scandal and cover-up at Daiwa Bank in 1995 arising from trading losses incurred at its New York branch, the court held that representative directors and certain executive directors are obligated to establish internal control systems and that other directors have the obligation to monitor the obligations of such representative directors and certain executive directors. In the case of a "large corporation," the court conceded that in practice it is difficult for all directors to monitor the day-to-day operations of other directors and stated that such directors should establish and maintain an internal control system and other systems necessary to assure the appropriate operation of the company.

Liabilities of Directors Due to Breaches of Their Duties

If the company (or a shareholder complying with the requirements for a derivative lawsuit) or a third party wishes to take action against a director, then the plaintiff has the burden to prove a breach by the director of his/her enumerated duty, the amount of damages suffered by the company or third party, and the causal link between the breach and the damage. A shareholder derivative lawsuit may be initiated by a shareholder who owns one or more shares and, in the case of a public company, the shareholder has owned the company's shares for at least six continuous months.

Directors will not be held liable if they can demonstrate that they did not fail to exercise their duty of care of a prudent manager in connection with the performance of their duties. A director's satisfaction of the duty of care of a prudent manager is usually evaluated under the equivalent of what is commonly termed the "business judgment rule." Under Japan's business judgment rule, established by the Supreme Court of Japan in *Apamanshop Holdings Co., Ltd.* (July 15, 2010), even if

directors make decisions that result in damages to the company, the directors will be deemed to have complied with their duty of care of a prudent manager, unless (i) the directors made material careless mistakes of "pertinent facts," (ii) the process of the directors' decision-making was significantly improper or the substance of the decision was significantly unreasonable, or (iii) one or more directors had a conflict of interest with the company with respect to the subject at hand. Reference to "pertinent facts" is broad and can vary depending on the industry in which the company operates, the company's financial situation, the operating business of which the director is responsible, and the expected role of the director (*i.e.*, executive directors are often expected to undertake greater "care" than ordinary directors due to their perceived greater industry knowledge).

Application of the business judgment rule does not always result in deference to board decisions. Japanese courts are expressly permitted to consider whether a reasonable basis exists for board decisions (unlike Delaware courts, which normally give wide latitude to the decisions of the board of directors, unless the plaintiff can satisfy a heavy burden of proof), so Japan's business judgment rule provides relatively narrow protection of board decisions (as reasonable decisions normally do not attract liability in the first place). As seen in the TEPCO case, the Tokyo District Court agreed with the shareholder plaintiffs that four former executive directors should have recognized the possibility of a huge tsunami hitting the power plant complex based on a 2002 government study and the executive directors failed in their duty of care of a prudent manager to promptly order appropriate tsunami countermeasures. The court was not persuaded by the defendant directors' arguments that the 2002 government study reportedly was not credible in their expert opinion (so they should not have been required to follow the recommendations in the study), and it was impossible to reasonably predict the amount of damages that would occur from a large tsunami.

As mentioned, directors are exposed to potential liability towards the company and towards third parties who interact with them in their capacity as a representative of the company.

Each is discussed below:

Potential Liability towards the Company

Article 423 of the Companies Act states that a director is liable to the company when he/she is negligent in performing his/her duties (as enumerated above), and the business judgment rule does not relieve liability owed to the company. For example, a director could be liable if the director negligently overlooks the misconduct of another director, executive officer or an employee and the company suffers damages therefrom (as in the *Daiwa Bank* case discussed above), or the board of directors fails to adopt adequate disaster prevention measures (as in the *TEPCO* case discussed above).

In the following circumstances, there is a presumption of negligence without deference to the business judgment rule and directors have the burden of proving that they were not negligent in performing their duties when ***the company***:

- makes an issuance of shares where the actual value of an asset contributed to the company in exchange for shares to be issued is much less than the minimum value of the shares stated in the company's Articles of Incorporation (in the case of incorporation) or offering documents (in the case after incorporation);

- engages in a transaction that is in contravention of Japan's conflict of interest provisions;

- declares a dividend or conducts a share buyback in excess of the company's permissible "distributable amount" (as of the commencement of the transaction) or "deficit" (as of the end of the fiscal year); or

- offers a pecuniary benefit to a shareholder in exchange for the exercise of such shareholder's rights.

Even when directors are not negligent and have met their duty of care of a prudent manager, strict liability applies (*i.e.*, there are no defenses that a director can raise and the business judgment rule does excuse liability) when ***a director***:

- falsifies the performance of contribution by a subscriber of shares for subscription;

- engages in a transaction for himself/herself that is in contravention of Japan's conflict of interest provisions; or

- offers a pecuniary benefit to a shareholder in exchange for the exercise of such shareholder's rights.

Board authorization does not cleanse a director from liability if the director is found to have breached the duty of care of a prudent manager and the subject transaction causes damages to the company. Furthermore, if improper 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 bad act (and will be held jointly and severally liable with the breaching director for damages to the company). Directors who participated in the board resolution are presumed to have assented to such resolution, unless the board minutes stipulate that a particular director expressed dissent. For example, if the business terms of a conflict of interest transaction turn out not to be arms-length, then the conflicted director and the other members of the board could be jointly and severally liable for the damages caused to the company because the directors breached their duty of care of a prudent manager (by not complying with their duty of loyalty) by approving an unfair transaction. Accordingly, legal counsel should be consulted if there is an appearance of a director conflict so appropriate procedures can be implemented.

Potential Liability towards Third Parties

Civil Liabilities. Directors can be liable to third parties (including shareholders) if they acted in bad faith or with gross negligence in connection with the performance of their duties that results in damages to the aggrieved third party (a more stringent standard than the ordinary negligence threshold for potential liability owed towards the company, as discussed above). Furthermore, pursuant to Article 429(2) of the Companies Act (a special statutory liability provision intended to protect third parties engaging in transactions with a Japanese company), a director is liable to compensate a third party for the damages they incurred if the director acts in bad faith or with gross negligence when performing duties for the company that lead to the provision of false information in any of the following activities:

- 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; or

- making a false registration or giving a false public announcement.

Not only is the director who commits any such misconduct liable, but any director who does not exercise a due level of care in monitoring that director also may be liable.

Criminal Liabilities. In addition to civil liability, a director can be held criminally responsible. For example, a director 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 director is generally not held criminally responsible for the criminal acts of the company.

Methods to Limit Director Liability

Unlike the corporate laws of many U.S. states, which permit the inclusion in a company's organizational documentation of a general provision that the company will indemnify, advance expenses, and hold harmless directors to the maximum extent permitted by law, the inclusion of a similar provision in the organizational documentation of a Japanese company would have little force or effect. Instead, the civil liability of a director can be limited only by applying specific liability limitation techniques, which distinguish shielding liabilities owed to the company versus third parties (unless D&O insurance is purchased):

Techniques to Limit Liabilities Owed to the Company

Statutory Cap. If a director acted in good faith and without gross negligence in connection with the performance of his/her fiduciary duties owed to the company, then a director's monetary liability towards the company arising from a breach of such fiduciary duties can be capped at a statutory amount, subject to certain strict approval procedures.

The statutory cap amount depends on the status of the director at the time of the breach and is a multiple of the director's "total annual remuneration," which is the sum of the director's (i) highest annual base salary, (ii) highest annual bonus, (iii) the equivalent of one year's retirement allowance (if such allowance is available to the director), and (iv) the value of any stock option benefits that have been exercised by the director:

- *For a representative director* (*daihyo-torishimari-yaku*) *or representative executive officer* (*daihyo-shikko-yaku*): the statutory cap is six times such representative director's or representative executive officer's total annual remuneration.

- *For a director with executive authority or an executive officer (other than the representative director or the representative executive officer)*: the statutory cap is four times such director's or executive officer's total annual remuneration.

- *For other directors*: the statutory cap is two times such director's total annual remuneration.

To effect a statutory cap on liability, either (i) all of the company auditors or the members of the company's audit committee must agree to propose the liability limitation to the shareholders and the proposal must receive the approval of shareholders owning two-thirds or more of the company's outstanding voting rights (Article 425 of the Companies Act), or (ii) all of the company auditors or the members of the company's audit committee must agree to propose the liability limitation to the board of directors, and the company's board of directors must approve the cap (so long as the company's Articles of Incorporation permits the directors to approve this type of arrangement), unless shareholders owning 3% or more of the company's outstanding voting rights object to the board of director's approval (Article 426 of the Companies Act). The details of the subject breach, the liability amount that will be discharged due to the adoption of the statutory cap and the reasons for such discharge must be disclosed in the shareholders or board of directors meeting, as the case may be, held to approve the statutory cap.

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/her conduct always will be covered by the statutory cap, so a director will be exposed to the risk of the cap's ultimate unavailability.

Liability Limitation Agreement. Pursuant to Article 427 of the Companies Act, a company may enter into an agreement to limit the liability of its non-executive directors towards the company for breaches of their fiduciary duties, so long as the director(s) acted in good faith and without gross negligence and the company's Articles of Incorporation permit the entry into such arrangement. If so, then the liability can be limited to the *larger of* (i) the amount stated in the company's Articles of Incorporation and (ii) the statutory cap for "other directors" (as discussed above). If the company is a public company, then the material provisions of the liability limitation agreement must be disclosed to its shareholders in the company's upcoming annual business report (*jigyo-hokoku*). Furthermore, when an incident occurs that could be covered by a liability limitation agreement, the company is required to disclose in its immediately upcoming shareholders meeting the material details of the subject breach, the liability amount that will be discharged and the reasons for such discharge.

A liability limitation agreement can be viewed more favorable in comparison to the application of the statutory cap because no shareholder approval is required and the arrangement is typically executed in connection with the appointment of the non-executive director; therefore, the limitation is effective before the misconduct is committed (which provides the non-executive director with upfront comfort concerning liability limitation). Executive officers cannot benefit from a liability limitation agreement.

Unanimous Shareholder Approval. Pursuant to Article 424 of the Companies Act, a director can be exempted from liability owed to the company arising from a breach of his/her fiduciary duties, even if the director acted in bad faith or with gross negligence, so long as all of the company's shareholders (including shareholders owning non-voting shares) agree to absolve the director after the disclosure of all material facts. However, if the fiduciary breach involves a director's approval of a dividend the amount of which exceeds the permissible distributable amount, then not even unanimous shareholder approval can reduce a director's liability in such instance. The unanimous shareholder approval option may not provide great comfort to a director because a director cannot assume upfront that his/her conduct will receive the requisite

shareholder approval, and obtaining unanimity could be difficult if the company has numerous shareholders.

Technique to Limit Liabilities Owed to Third Parties

Indemnification agreement. Since March 1, 2021, a Japanese company has been permitted to enter into an agreement under the Companies Act to (i) indemnify its directors against damage awards or settlement amounts paid or owed by directors to third parties (but not the company under a derivative lawsuit or otherwise) on claims arising from their performance as directors of the company (except criminal or administrative fines or surcharges imposed on directors), and (ii) pay reasonable expenses (including, reasonable defense costs) incurred by its directors to defend themselves in proceedings. Reasonable expenses can be advanced to the director. Moreover, even if it is subsequently determined that a director acted in bad faith or with gross negligence, the director will not be obligated to repay the advanced expenses to the company, unless the director caused "damage" to the company or engaged in activities to earn an "illegal profit" (with these exceptions open to broad interpretation given their vagaries). On the other hand, a director is not entitled to receive indemnification for payments of monetary awards or settlement amounts if the director is found to have acted in bad faith or with gross negligence.

Indemnification agreements can be entered into between a company and its directors as early as upon the appointment of the director (*i.e.*, prior to the occurrence of the incident giving rise to potential liability), or even after the occurrence of an incident giving rise to potential liability (though earlier adoption is preferable). As entering into an indemnification agreement presents a conflict of interest and may affect the impartiality of the execution of a director's duties, the Companies Act requires that the entry receive (i) majority approval of the board of directors of the company (with the director who is the beneficiary of the proposed indemnification agreement abstaining from the deliberations and the vote on the matter), or (ii) the approval of shareholders owning a majority of the company's outstanding voting rights if the company has not adopted a board of directors corporate governance form. If the company is a public company, then the material provisions of the indemnification agreement must be disclosed to its shareholders in the company's annual business report (*jigyo-houkoku*).

The foregoing indemnification requirements apply only if a Japanese company directly enters into an indemnification agreement with its directors. An overseas parent company, on the other hand, is not prohibited under the Companies Act from entering into an indemnification agreement with the directors of its Japan subsidiary. Therefore, an overseas parent may prefer to directly extend indemnification benefits to the directors of its Japan subsidiary if the laws of the parent company's home jurisdiction permit such entry (and the adoption procedures are followed), and the overseas indemnification laws are viewed as more favorable by the parent company and the director. Legal counsel should be consulted if a company seeks to indemnify a former director after his/her retirement or resignation under an indemnification agreement or to newly enter into an indemnification agreement with a former director because it is unclear whether coverage is legally permissible under these circumstances.

Unanimous Shareholder Approval. Scholars contend that a company should be able to provide a director with an upfront full indemnity against third party claims so long as all of the company's shareholders approve the arrangement. With the adoption of the indemnification agreement approach discussed immediately above, some may argue that a full indemnity is no longer consistent with the Companies Act. On the other hand, the indemnity agreement approach seems most suitable for a public company given its flexible adoption thresholds. If all the shareholders of a company knowingly and willingly agree to provide directors with a full indemnity (subject to limited exceptions), it could be difficult to argue why the shareholders should be deprived of this decision. Clearly, the unanimous shareholder approval requirement would lend itself most suitable to a privately owned company where the shareholders act as a group.

Technique to Limit Liabilities Owed to the Company and Third Parties

Insurance. D&O insurance is widely used by public companies in Japan to entice outside directors to become board members (though its availability is open to all directors) by shielding their personal liability and covering their defense costs. D&O insurance is also available for privately owned companies, though the need under such circumstances may be limited as the likelihood of suits should be limited (unless the privately owned company is a subsidiary with substantial assets, in which case, the shareholders of the

parent could have standing to make a claim against the directors of the subsidiary, or the subsidiary engages in an industry that is susceptible to third party claims).

D&O insurance underwritten in Japan generally covers economic damages and defense costs up to the policy limits for claims made against directors during the policy period arising from the decisions and actions taken by directors within the scope of their duties. D&O insurance in Japan is typically underwritten on a claims-made basis, not an occurrence basis. Coverage varies by insurer and policy to policy, but generally speaking, D&O insurance often is not available (or the coverage is limited) with respect to a claim involving (i) gaining of profit or advantage for which the director was not legally entitled, (ii) any criminal, dishonest or fraudulent act or omission, or an intentional violation of law, rule or regulation, (iii) bodily injury and property damage, or (iv) U.S. securities laws. Since 2016, a company can pay on behalf of the director the full D&O policy premium without treating a portion of such amount as a taxable fringe benefit to the director (previously, the director often paid the premium for coverage handling derivative lawsuits due to a perceived conflict of interest if the company paid for this type of insurance).

The provision of D&O insurance to a director must receive (i) majority approval of the board of directors of the company (with the director who is the beneficiary under the policy abstaining from the deliberations and the vote on the matter), or (ii) the approval of shareholders owning a majority of the company's outstanding voting rights if the company has not adopted a board of directors corporate governance form. If the company is a public company, then the material provisions of the D&O policy also must be disclosed to its shareholders in the company's annual business report (*jigyo-houkoku*).

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

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The Tokyo District Court's July 13, 2022 decision ordering four former executive directors of TEPCO to jointly and severally pay JPY 13.32 trillion (USD 97 billion) to the company is a breathtaking reminder of the massive liabilities to which directors of a Japanese company can be exposed. Senior ex-TEPCO directors were held personally liable for failing to implement adequate tsunami precautions arising from a government study even though (i) in September 2019, the Tokyo District Court cleared the same directors from criminal responsibility for the accident, and (ii) a month earlier, Japan's Supreme Court held that the Japanese government was not required to pay Fukushima residents compensatory damages arising from the nuclear disaster because a tsunami of that magnitude was not foreseeable. Of course, the standard of proof is not the same across lawsuits. However, the magnitude of the damages awarded in the TEPCO civil case sends a torpedo across the bow that may reduce the willingness of individuals to serve as a director of a Japanese company, especially if the company operates in an industry that is capable of causing wide-scale damages. At the same time, one should not deflect culpability for the horrific pain, suffering and damage that will last for generations caused by the accident at the Fukushima nuclear power complex and its aftermath.

In light of the TEPCO decision and its future implications, Japanese companies should promptly remind directors of their fiduciary duties, implement adequate controls, and ensure that suitable liability protective measures are in place so qualified individuals will not be deterred from serving as directors. Legal counsel can assist in providing this training and recommending best practices.

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