Liability through an Olympus lens

Asa Shinkawa, Hiroko Shibata and James Emerson of Nishimura & Asahi examine civil liability for misstatements in Japanese securities disclosures in the light of the recent Olympus scandal

Every so often a cataclysmic event rocks the Japanese legal world. The scandal that enveloped Olympus Corporation in late 2011 is a recent and important example.

On November 8 2011, the digital camera and precision instruments manufacturing corporation acknowledged the improper deferment of losses since the 1990s from certain securities and derivatives investments and promised to cooperate with an external review committee to clarify such accounting practices. The external review committee's report on December 6 2011, available at www.olympus-global.com/en/info/2011b/if111206corpe.html, concluded that accounting manoeuvres, sometimes referred to in Japanese as *tobashi* (meaning 'flying away'), were apparently used to make securities and derivatives with large unrealised losses fly off Olympus' balance sheets and onto those of offshore shell companies.

More precisely, these accounting manoeuvres consisted of transactions whereby offshore shell companies purchased poorly-performing financial assets from Olympus at book value, with funds substantially contributed by Olympus and bank loans secured by Olympus' deposits, and so that the shell companies could return the funds and repay the bank loans, Olympus directly or indirectly paid an excessively high acquisition price or financial advisory fees to the offshore shell companies in connection with several M&A transactions. Consequently, Olympus recognised the excessive amounts or the differences between the amounts paid and the fair value of such M&A transactions as good will, which constitutes a depreciation asset under accounting rules, and tried to amortise the same over 10 to 20 years. In keeping with the external committee's findings, Olympus announced on December 14 2011 that the offshore shell companies should have been consolidated, since Olympus substantially contributed to and controlled those companies.

The *tobashi* scheme had covered up losses amounting to approximately ¥118 billion ($1.5 billion), and so the company filed amendments to its financial reports for the past five fiscal years to properly reflect such losses.

Shortly thereafter, two additional external review committees issued a report on January 7 and January 16 2012, respectively, concluding that certain former and current directors and statutory auditors of Olympus should be held liable for breaching their fiduciary duties. In response, Olympus filed a claim for damages on January 8 against 19 former and current directors, and a similar claim on January 17 against five former and current statutory auditors.

On December 21 2011, the Japanese Securities and Exchange Surveillance Committee (SESC), in collaboration with the Tokyo District Public Prosecutors Office and the Tokyo

"The *Olympus* case shines a spotlight on contemporary Japanese securities litigation"

Metropolitan Police, initiated searches and seizures as part of a criminal investigation into the activities of former and current Olympus management and began to examine misstatements in Olympus' securities disclosure documents to determine whether a violation of Japan's Financial Instruments and Exchange Act (FIEA) and other applicable laws and regulations may have occurred.

Next, a wave of claims from various interested parties ensued. According to *Nikkei Shimbun* articles, on January 17 2012 an Olympus shareholder brought a derivative lawsuit against former and current directors, demanding compensation for damages arising from alleged breaches of the directors' fiduciary duties. Then, on January 24, a separate set of Olympus shareholders filed a civil tort lawsuit against Olympus seeking compensation for the material misstatements that had appeared in the company's securities disclosure documents.

> **"There is a maximum cap with respect to the amount of damages recoverable by short-term and ordinary market investors"**

Securities litigation in Japan today

The *Olympus* case is a critical one because it shines a spotlight on contemporary Japanese securities litigation. In recent years, the number of misstatement claims brought by investors against companies issuing securities has been rising. According to a report published by National Economic Research Associates in July 2009 and available at www.nera.com/extImage/PUB_Recent_Trends_Japan_English_0709.pdf, from calendar year 1998 through 2003, only five lawsuits were filed in Japan regarding misstatements in securities disclosure documents. In contrast, 2005 through 2008 saw that number of lawsuits, or more, every single year (for reference purposes, the number of relevant lawsuits was five, eight, eight and 13 in those years). Although that number of claims is modest in comparison to the number of misstatement claims brought annually in the United States, it indicates that 2004 was a significant turning point in the direction of more misstatement-related lawsuits in Japan, which were encouraged by an amendment to the FIEA that came into effect on December 1 2004.

Before the 2004 amendment

Before the 2004 amendment to the FIEA, investors who had obtained securities through a secondary market such as a public stock exchange were forced to bring claims relating to misstatements in publicly available disclosure documents under Japanese general tort law, where a misstatement means either the presence of material, false information or statements, or the omission of the same when such information should have been stated to avoid a misunderstanding by a rational investor. In such cases, the secondary market shareholder-plaintiffs needed to prove all of the following elements, each of which may be difficult to demonstrate in court: (i) the issuing company's knowledge of, or negligence regarding, the misstatement; (ii) proximate causation – the issuing company's misstatements being the cause of the plaintiff's damages; and (iii) the amount of damages actually incurred by the plaintiff.

About the author

Asa Shinkawa has been a partner in the M&A/Corporate Group at Nishimura & Asahi since 2000. She focuses on M&A, tender offers, cross-border and domestic acquisitions and divestitures and going private transactions, restructurings and spin-offs, joint ventures and numerous other kinds of M&A and commercial arrangements across various industries.

She has also advised extensively on the application of antitrust/competition law in relation to M&A transactions, joint ventures, cooperative arrangements between competitors, sole-distributorship arrangements, distribution agreements, dealer agreements and other types of commercial arrangements.

She is a graduate of The University of Tokyo (LL.B., 1989) and Harvard Law School (LL.M., 1997) and is admitted to practice law in Japan (1991) and New York (1998). Shinkawa is a frequent contributor to both Japanese and English language publications, and speaks Japanese and English.

Contact information

Asa Shinkawa
Nishimura & Asahi

Ark Mori Building
(Main Reception: 28th Floor)
1-12-32 Akasaka, Minato-ku
Tokyo 107-6029

t: +81 3 5562 8500
f : +81 3 5561 9711/12/13/14
w: www.jurists.co.jp

However, both before and after the 2004 amendment, investors acquiring securities through a primary offering that involved the actual receipt of disclosure documents, such as a securities registration statement and prospectus, were afforded the benefit of certain legal presumptions provided under the FIEA that greatly eased the burden of proving the three elements in misstatement cases brought by primary market investors.

The rationale for the disparity in treatment for primary market investors and secondary market investors before the 2004 amendment was that, as issuing companies are the cause of damages from misstatements in their disclosure documents provided at the time of the offering, it is reasonable to allow primary market investors to recover losses as a result of the misstatements by alleviating their burden of proof. In the case of secondary market investors, however, issuing companies were not in a position to benefit from the sales and purchases of shares in the secondary market, and therefore it was considered inappropriate for the issuing companies to always be required to compensate such investors for misstatement-related damages.

Expansion of assistance to secondary market investors

The 2004 amendment is noteworthy in that it expands FIEA support to the misstatement claims of secondary market investors.

It also varies the level of support provided to secondary market investors depending on whether they met certain requirements, namely, that they: (i) acquired the relevant securities, without knowledge of the misstatements, at a time when the relevant disclosure documents containing the misstatements were available for inspection by the public; (ii) acquired the securities within one year of the day on which an announcement pertaining to the misstatements was made by the issuing company or an authority with power relating to the company's assets or business under relevant laws (in other words, the announcement date); and, (iii) continuously possessed the securities at least until the announcement date. Secondary market investors who qualify under these terms are referred to in this article as short-term investors.

FIEA presumptions

In the case of misstatement claims brought by primary market investors, the FIEA rules presume that issuing companies are the cause of damages from misstatements in their disclosure documents, even when they have no knowledge of, and have not been negligent regarding, such misstatements. This basic presumption assists primary market investors in meeting their knowledge or negligence and causation burdens.

Additionally, the FIEA provides a presumption that the damages of primary market investors harmed by disclosure document misstatements are equal to the difference between the purchase price of the relevant securities, and the market price thereof at the time of the claim for damages, or the transfer price if the relevant securities were disposed of before the claim was initiated. The burden of proving actual damages is also alleviated.

As a result of the 2004 amendment, short-term investors also benefit from the basic presumption, and are entitled to a presumption of damages that is equal to the difference between the average market value for the relevant securities over the period of one month, beginning one day after the announcement date, and the average market value for such securities during the one-month period before, but not including, the announcement date.

Some secondary market investors are not short-term investors, and are classified instead as ordinary market investors, because they do not meet all of the relevant requirements, for example, because they purchased their shares in the market more than one year before the announcement date. Thanks to the 2004 amendment, ordinary market investors still enjoy a presumption of knowledge or negligence on the part of the issuing company for misstatements present in publicly available

About the author

Hiroko Shibata joined Nishimura & Asahi in 2001 and is an associate in the M&A/Corporate group. Her practice focuses on domestic and cross-border acquisitions, leveraged buyouts and corporate preparedness and takeover defensive measures.

In 2008, she worked at the Ministry of Foreign Affairs of Japan to help negotiate free trade agreements and investment agreements, where she strengthened her expertise in regulations, especially restrictions on foreign investments imposed on cross-border transactions. Since returning to Nishimura & Asahi in 2009, she has been deeply involved in advising clients on cross-border acquisitions and other strategic corporate transactions.

Ms. Shibata is a graduate of The University of Tokyo (LL.B., 1998) and University of California, Berkeley (LL.M., 2007) and is admitted to practice law in Japan in 2001 and New York in 2008.

Contact information

Hiroko Shibata
Nishimura & Asahi

Ark Mori Building
(Main Reception: 28th Floor)
1-12-32 Akasaka, Minato-ku
Tokyo 107-6029

t: +81 3 5562 8500
f : +81 3 5561 9711/12/13/14
w: www.jurists.co.jp

disclosure documents at the time such investors acquired the securities, provided those investors had no knowledge of the existence of the misstatements at such time. Ordinary market investors do not qualify for causation or damages presumptions, however, which means that their claims are more challenging to prove in court than those of primary market investors and short-term investors.

Other limitations

There is a maximum cap with respect to the amount of damages recoverable by short-term and ordinary market investors under the 2004 amendment, which is the amount of the difference between the purchase price of the relevant securities by the investor and the market price of relevant securities at the time the damage claim is brought, or the transfer price if the relevant securities have been disposed of before filing the damage claim.

Additionally, the FIEA permits courts to reduce damage awards to a reasonable extent if all or part of the investors' damages were attributable to a cause other than the decline in value of the relevant securities resulting from the misstatement and it is extremely difficult to prove what portion of the investor's damages are attributable to such other factors. Although, in practice, it may be a great challenge for issuing companies to convince courts that investors' damages arose from sources other than the misstatements.

Resolving Olympus-related lawsuits

Among other issues, the determination of the announcement date will likely be a significant point of contention in the *Olympus* case. One potentially relevant legal precedent is a decision rendered by the Tokyo District Court on June 13 2008 in a case involving Livedoor. In this case, the court ruled that the announcement date for purposes of a misstatement civil liability claim by shareholders was the date on which public prosecutors announced to the media an allegation that Livedoor's annual securities reports contained a false current-accounting surplus amounting to approximately $14 million.

The court's decision was based on its ruling that an announcement for purposes of the FIEA should consist of any communications or measures that make relevant facts knowable by the general public. Such announcement need not be exclusively made by the issuing company, but can be made instead by any authority with the right to require a report from, conduct a review of, or investigate the issuing company.

The court also ruled that if such authority or the issuing company substantially rectifies the misstatements by disclosing the relevant omitted information or correcting the inaccurate information in the disclosure documents, then such actions may constitute an FIEA announcement because they enable the market to respond.

In the *Olympus* case, substantive public announcements relating to misstatements in its securities disclosure documents were made on at least three different dates: November 8, 10 and 14, 2011. However, while Olympus first admitted on November 8 that it had been deferring the posting of losses on its investments since around the 1990s and had made a series of fee and acquisition payments to cover up its loss deferrals, detailed numerical information regarding such misstatements and the total amount of Olympus' improperly concealed losses were not made public until Olympus amended its financial statements on December 14. On the other hand, Olympus' share price bottomed out on November 10, which was the date when Olympus announced that it would not be able to file its quarterly financial reports by their due date on account of the investigation then being conducted by the external review committee. It was also the date on which the Tokyo Stock Exchange announced that Olympus' shares would be designated as "securities under supervision" due to the financial reporting delay – which, in turn, suggested the possibility that Olympus' shares might be de-listed, a possibility that has since been eliminated. Also, before December

About the author

James Emerson is a senior foreign attorney and member of the cross-border transactions group at Nishimura & Asahi. His practice focuses on international M&A, complex commercial real estate, project finance and capital markets transactions.

Prior to joining Nishimura & Asahi in 2009, Emerson was an associate at Skadden Arps Slate Meagher & Flom in New York and at Morrison & Foerster in Tokyo.

Emerson graduated, Phi Beta Kappa and summa cumulative laude, from the University of Southern California in 1996. He also earned a master's degree from Cambridge University in 1997 and his JD degree from Harvard Law School in 2003. Emerson is admitted to the United States Court of Appeals for the Third Circuit and is admitted to practice law in New York.

He is a native English speaker and is proficient in Japanese.

Contact information

James Emerson
Nishimura & Asahi

Ark Mori Building
(Main Reception: 28th Floor)
1-12-32 Akasaka, Minato-ku
Tokyo 107-6029

t: +81 3 5562 8500
f : +81 3 5561 9711/12/13/14
w: www.jurists.co.jp

14 2011, the media reported on various occasions that the Securities and Exchange Surveillance Committee and Tokyo District Public Prosecutors Office would commence an investigation. It appears, however, that at the time of writing no corroborating public announcement by any of those investigating authorities has been made.

This means, as a preliminary matter, that Japanese courts will need to decide whether the mere mentioning of the existence of misstatements is an appropriate trigger-event for announcement date determination, or whether the public release of hard figures on which investors can make better-informed investment decisions should take priority. Japanese law on this point is unclear. Likewise, there is a question as to whether or not investors who acquired their shares in Olympus after November 8 2011 deserve FIEA support. The courts could adopt the view that the market was afforded adequate notice of the existence of accounting misconduct, and thus was able to respond and reflect such misconduct in the market price of the securities, even if the precise magnitude and nature of that misconduct was not yet known at the time. If so, the announcement date could be set as of November 8 2011.

Damage calculations for ordinary market investors

Keep in mind that the announcement date is crucial, not only with respect to the calculation of damages, since it will establish which time periods are relevant for the calculation, but also with respect to identifying which secondary market shareholders will qualify as short-term investors and which will merely be ordinary market investors – as all three FIEA presumptions are available to short-term investors, whereas only one of those presumptions is given to ordinary market investors.

In this regard, a recent Japanese Supreme Court case suggests that ordinary market investors may have assistance in showing their actual damages if they can demonstrate that they would not have purchased the relevant securities but for the misstatements.

On September 13 2011, the Supreme Court of Japan held Seibu Railway liable to its shareholders for misstatements regarding the share ownership percentage of its controlling shareholder, which, unbeknownst to the public, had crossed the threshold for delisting on account of insufficient share liquidity, and such condition had persisted since 1943.

In that case, Seibu Railway made a public announcement regarding the misstatement on October 13 2004, less than two months before the effective date of the 2004 amendment, so Seibu Railway shareholders that had obtained their shares through the secondary market could not at such time qualify for any of the FIEA presumptions, and, therefore, their claims were purely tort law-based.

In *Seibu Railway*, the Supreme Court ruled that in tort cases where a given investor-plaintiff can show that it would not have purchased the shares but for the misstatement in the relevant disclosure documents, then where the other elements of the plaintiff's case are also shown, the amount of damages should be calculated using one of the following formulae: (i) if the plaintiff sold the shares after the announcement of the misstatement, the difference between the purchase price and the sale price of the shares; or (ii) if the plaintiff continues to hold the shares, the difference between the purchase price and the market price prevailing at the conclusion of the court hearings for the case. Or, if the shares have been de-listed by that time, then the appraisal value of the shares at such time.

The Supreme Court also ruled that issuing companies should not be held liable to the extent that lower share values can be attributed to any factor that is unrelated to the misstatements, such as macro-economic circumstances, market trends, or even the poor performance of the company generally. In *Seibu Railway*, the ruling on this point was divided between lower courts – the Tokyo District Court and the Tokyo High Court – and the Supreme Court. Furthermore, the Supreme Court has stated that while the occurrence of panic-selling in the market, as a reaction to the misstatements in securities disclosure documents, may be a predictable and widespread phenomenon, it is not a reason for allowing the issuing company that made the misstatements to skirt liability.

Whether the *Seibu Railway* formulae for damages calculations will apply in *Olympus* is an issue which may depend on whether the relevant shareholders would not have purchased the securities but for the misstatements in the disclosure documents. In such a way, the *Olympus* case could be a helpful indicator of the range of applicability of the *Seibu Railway* damages calculations.

Looking ahead

The 2004 amendment purported, among other things, to strengthen the enforcement of the FIEA's disclosure requirements through damage claims brought by secondary market shareholders. Although the deterrent effects of the 2004 amendment are appreciated as a means of discouraging financial statement window dressing and the making of other misstatements in disclosure documents, it is important to realise that allowing secondary market shareholders to recover damages from issuing companies means that those plaintiff-shareholders will receive compensation for their losses at the expense of other shareholders of the issuing company, insofar as the issuing company's cash is diverted away from the company and into the pockets of that small subset of secondary market investors.

Moreover, when plaintiff-shareholders prevail in their claims, they become unsecured creditors of the company, which could distort the level of investment risk. If misstatement litigation levels continue to rise, it may be necessary to reconsider such allocation of risk as a matter of public policy.